A CRITICAL ANALYSIS OF STATUTORY DEEMING IN THE CONTEXT OF THE INTERACTION BETWEEN SOUTH AFRICA'S CONTROLLED FOREIGN COMPANY REGIME AND MODEL-BASED BILATERAL TAX TREATIES

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Declaration

This research dissertation is presented for the approval of Senate in fulfilment of part of the requirements for the Master of Laws in approved courses and minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

I hereby declare that I have read and understood the regulations governing the submission of the Master of Laws dissertation, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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Abstract

Fiction in domestic tax law is a peculiar legal construct. Set in contradiction, the result is plainly counter-factual. The question arises as to what the fiction means when constructed in the context of tax treaties? This minor dissertation draws a comparative analysis between the statutory construction of two opposing international tax treaty cases, one more recent than the other, in regard to the effect of one particular fiction in domestic tax law – the *'as if'*.

In 1997, the United Kingdom court of appeal ruled on *Bricom Holdings Limited v IRC.* The finding from that decision surrounded the interpretation of the *'as if'* fiction in British Controlled Foreign Company (CFC) rules. In that case, the court found that the reference to *'as if'* was a purely notional definition based on fictional assumptions. These assumptions resulted in a product of artificial calculation, such that when constructed in CFC rules, resulted in a tax charge that was not a charge on the CFC's actual income, but a notional amount based on a notional definition of that income. The notional amount could, therefore, not be provided relief by way of tax treaties. In 2000, South Africa followed the British court's reasoning by updating its domestic Controlled Foreign Company rules with the same *'as if'* terminology.

In 2018, the principle which formulated that longstanding argument appeared to be rejected by the same British court in the decision of *Fowler v HMRC.* The court of appeal reached the opposite result by finding that the fiction arising from the *'as if'* terminology did not represent a notional tax charge. Instead, the *'as if'* assumption created a new and exclusive taxable subject matter on the same income source, alike to statutory deeming. The fictional income arising from that fictional treatment was the substitution of one (notional) source of taxable income for another (actual, but disregarded) source. The deemed character in the computation was, therefore, retained in tax treaties, allowing tax treaty relief.

This minor dissertation analyses both cases in order to posit whether or not the net income imputed from South Africa's CFC rules, using the same *'as if'* terminology, may be construed as a deeming rule on the same CFC's income. The finding in this minor dissertation is that an *'as if'* fiction may not represent a purely notional definition. The computation of CFC net income in tax treaties may, therefore, be afforded tax treaty relief akin to statutory deeming.

CONTENTS

CHAPTER ONE – A TAXING ARGUMENT

1.1. Introduction

Legal fictions are peculiar intellectual constructs. They attach legal consequences and yet they are in clear opposition to fact and plainly self-contradictory.[1] One example can be seen in the effect arising from the plain words *'as if'*. Alone, the words '*as if'* are not self-evident and have no meaning without a given context. Rather, it is when *'as if'* is woven between an opposing subject matter that the legislative instruction giving this fiction its explanatory power is created.

In legal theory, the *'as if'* fiction has long had its own theoretical underpinning.[2] Predominantly, writers on this subject refer to *The Philosophy of the As-If* by *Vaihinger* as well-known.[3] The premise follows a simple logic:

> 'In a fiction we treat X *as if* it were Y to better understand…[X], we very well know that X actually is not Y or cannot be Y.'[4] Rather, the legislative effect normatively *makes* X a Y.[5]

The full effect of the *'as if'* fiction above means that the same normative consequences which attach to Y, attach to X, because the fiction attaches to X. X is, therefore, indistinguishable from Y from the point of view of the fiction.[6]

Interestingly, the logic of this theoretical underpinning has not had the same consistent effect in both domestic tax law and tax treaties. In 1997, for example, a hallmark tax treaty case known as *Bricom Holdings Limited v Inland Revenue Commissioner* was decided by the United Kingdom court of appeal.[7] The case surrounded a provision in the United Kingdom domestic tax law that contained an *'as if'* fiction. This stated:

> '…a sum equal to corporation tax…on that apportioned amount of profits…of a controlled foreign company…shall be assessed…from the resident company as if it were an amount of corporation tax chargeable on that company.'[8]

[1] Christoph Kletzer 'Kelsen on Vaihinger' M. Del Mar & W. Twinnings (eds) *Legal Fictions in Theory and Practice* (Springer International Publishing 2015) Ch. 2, at 23-4.
[2] Ibid.
[3] Ibid.
[4] Ibid.
[5] Ibid.
[6] Ibid.
[7] *Bricom Holdings Ltd. v IRC* 1997 (1) ITLR 365 (EWCA Civ).
[8] Ibid at 371.

The taxpayer was a United Kingdom corporate resident assessed on the above provision. The taxpayer appealed the assessments finding that the *'as if'* fiction meant that the sum 'equal to' corporation tax was charged on the profits of the controlled foreign company (CFC).[9] The taxpayer claimed this had the effect that the CFC was assessed on double resident-based taxation and may be resolved by way of tax treaty.[10]

The court, however, dismissed the appeal in a unanimous judgment, finding that the reference to *'as if'* was a statutory hypothesis that represented an artificial calculation.[11] The assumptions to which the actual profits were applied were not additional assumptions applied in combination with actual facts, instead, the profits to which the assumptions applied were substituted with notional definitions.[12]

The result was that the subject matter arising from those assumptions had no identity whatsoever. The court, therefore, resolved that the fiction had nothing to do with the actual profits or actual residence of the foreign corporation.[13] The fiction existed only as a measure of imputation, and therefore, had no effect in tax treaties.

In 2000, South Africa updated its CFC legislation based on the *Bricom* judgment.[14] This included the terms 'equal to' and 'as if' on a similar premise that the *'as if'* was a notional measure.[15] *'As if'*, however, is not defined in South African tax law. The common law meaning derived from the *Bricom* case has not been referred to or raised as a similar matter in South African courts.

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[9] Ibid at 379.
[10] Ibid at 376.
[11] Ibid at 376-7.
[12] Ibid.
[13] Ibid.
[14] Annet Wanyana Oguttu 'Resolving the Conflict Between Controlled Foreign Company Legislation and Tax Treaties: A South African Perspective' (2009) 42(1) *Comparative and International Law Journal of Southern Africa* 73 at 103.
[15] See Chapter 2.2. Since 1988, *'as if'* appeared in only three provisions in United Kingdom domestic tax law – see Daniel Sandler *Tax Treaties and Controlled Foreign Company Legislation Pushing the Boundaries* vol 2 (Kluwer Law International 1998) at 211 fn 75. It has, however, been litigated in all three occurrences. First in 1994, section 419(1) – see Chapter 2.4.1 of this minor dissertation dealing with members loans in the *Bracken* case (non-tax-treaty decision). Second in CFC rules section 747(4)(a) in the *Bricom case* in 1997. Last in the *Fowler* case in 2018 regarding divers (a provision first appearing in 1988 in the former section 314(1)). The author of this minor dissertation is not aware of a provision that uses the *'as if'* terminology elsewhere in South African tax law.

In 2018, the difficulty of interpreting the effect of *'as if'* resurfaced in the United Kingdom court of appeal. The decision in *Fowler v Revenue and Customs Commissioners* was a ruling that directly contrasted the court of appeal's earlier view regarding the effect found in the *Bricom* matter.[16] This decision was not unanimous, but the majority view is noteworthy insofar as what it said about the effect of constructing *'as if'*.

The case dealt with a United Kingdom domestic tax law provision stating that employed commercial divers are *'treated as'* carrying on a trade. The provision under consideration underwent a redraft in 2005 that replaced *'as if'* with '*treated as'*. The explanatory note to the provision still referred to *'as if'*.[17]

The taxpayer, a South African tax resident, was assessed on diving activities performed in the United Kingdom on the basis of employment income. The taxpayer appealed those assessments by raising the argument that the income was income from trade, which was how the United Kingdom treated it. As a non-resident in the United Kingdom, the business profit tax treaty article dealing with income from trade would exempt the taxpayer from the assessment.

The question before the court was whether or not the distinction in language made any difference to the fictional assumption? The majority decision found that there was none. The terms *'treated as'* and *'as if'* were similar in their deeming nature, finding:

> 'The Income Tax Acts are directed to have effect 'as if' the performance by the relevant person of the specified duties of his employment 'constituted the carrying on by him of a trade…The effect of this language was to create a deemed trade, which could not exist simultaneously with the taxpayer's actual employment…a new source of taxable income was created, which supplanted his actual employment for all income tax purposes.'[18]

The court held that the income from the *'as if'* assumption was, therefore, the result of a *'deemed'* trade.[19] The court's reasoning was that the fictional assumption of trade could not co-exist with the fact of employment. In that view, the court held that there was no doubt that the *'as if'* fiction could replace the same source of actual income for a fictional source.[20] The

[16] *Fowler v HRMC* 2018 EWCA Civ 2544.
[17] See John Avery Jones 'Commentary' in *Fowler v Revenue and Customs Commissioners* 2018 (21) ITLR 388 (EWCA Civ) at 391.
[18] *Fowler* supra note 16 para 43.
[19] Ibid.
[20] Ibid.

income was, therefore, from a trade in both domestic tax law and in tax treaties, and exempt by way of tax treaty. Unlike the *Bricom* decision, however, this contrasting result meant that the fictional assumptions arising from the *'as if'* did not have a notional consequence.

The question arising in this minor dissertation, therefore, is what is the effect of the *'as if'* fiction? On the one hand, the *Bricom* decision, which seems to be the view of South Africa, finds that the *'as if'* was entirely notional. On the other hand, the *Fowler* decision held that the *'as if'* assumption was given a full fictional identity.

In light of this distinction, a significant theme in this minor dissertation surrounds the statutory construction of fiction and fictional income arising from the *'as if'* assumption in domestic tax law. Specifically, whether or not the fictional assumptions can be given an identity in tax treaties. This discussion follows the theoretical underpinning of *Vaihinger*, in that the subject matter X may assume the full identity indistinguishable from Y.

Additionally, the view that the *'as if'* fiction has a notional consequence in South African CFC rules is not settled.[21] The wording of South African CFC rules is not clear on the issue.[22] A similar issue to the *Bricom* case has not been litigated in South Africa. Whether or not *'as if'* may be given the full effect is thus debated.

1.2. The research problem

In 2002, the interaction between South African CFC rules and tax treaties was briefly described in an explanatory memorandum issued by National Treasury.[23] The memorandum stated:

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[21] See, for example, Anne Bennett & Le Roux Roelofse, *Controlled Foreign Companies* (SILKE on International Tax - Lexis Nexis 2017) ch 3 at 3.5.1; Lynette Olivier & Michael Honiball *International Tax: A South African Perspective* (5 edn, SiberInc 2011) at 608-9; Deborah Tickle 'The Taxation Of Foreign Passive Income For Groups Of Companies' (2013) 98A *IFA Cahiers* at 681 para 2; Oguttu, op cit note 14 at 76-7.

[22] Davis Tax Committee, *DTC Report on OECD Action 3: Strengthening Controlled Foreign Company Rules* (Annexure 3 Final Report 2016) at 6 point 4. Available: https://www.taxcom.org.za/docs/New_Folder3/5%20BEPS%20Final%20Report%20-%20Action%203.pdf, last accessed 30 June 2019.

[23] National Treasury, *National Treasury's Detailed Explanation to Section 9D of the Income Tax Act* (National Treasury of South Africa 2002) at 2 para C. Available: http://www.treasury.gov.za/divisions/tfsie/tax/legislation/Detailed%20Explanation%20to%20Section%209D%20of%20the%20Income%20Tax%20Act.pdf, last accessed 30 June 2019.

> 'The CF[C] legislation taxes the resident shareholders of the CF[C], and not the CF[C] itself. As the same resident is not being taxed twice on the same amount, no double taxation arises. It therefore cannot be said that the CF[C] legislation overrides any double taxation agreements.'
>
> 'Where the resident shareholder is taxed on foreign amounts that are calculated according to proportional holdings in the CF[C], this would amount to economic double taxation in the absence of the granting of appropriate foreign tax credits and not juridical double taxation.'[24]

This statement attests to the view that South African CFC rules do not tax the same taxpayer, on the assumption that double juridical taxation in tax treaties can only arise on the same taxpayer. It also says nothing of the nature of the 'income' that is taxed. That question, therefore, reverts to the effect of *'as if'*.[25] When the use of *'as if'* is given the fictional identity the same as that of the CFC, the same CFC's income is taxed on the residence basis of taxation by one or more resident taxpayers in one or more Contracting States. This is termed a resident/resident-based attribution.[26]

Resident/resident-based attributions appear to remain significantly unresolved on the objectionable basis that tax treaties relieve only juridical double taxation and that taxation of different persons on the same income is a form of economic double taxation.[27] That proposition is furthermore, said to be descriptive, not normative; it is also incomplete because, as below, tax treaties already provide relief against the taxation of different taxpayers on the same income.[28]

A recent example can be seen in the United Kingdom Supreme Court. In *Anson v HMRC*, the court found that tax treaty relief in cases of resident/resident-based attributions was dealt with by determining one critical point, namely *'whether the income taxed in one country is the same as the income taxed in another'*.[29]

There Lord Reed in regard to model-based tax treaties states:

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[24] Ibid.
[25] Discussed in Chapters Two and Three.
[26] 'Claims by different States to tax the same income on a residence basis arises where both attribute the income to the same taxpayer, whom both see as resident, or where each attributes the income to a different taxpayer, whom each sees as resident', see ML Brabazon, *Application of Tax Treaties to Fiscally Transparent Entities – Global Tax Treaty Commentaries* (IBFD 2018) para 4.7.
[27] Ibid.
[28] Ibid.
[29] *Anson v HMRC* 2015 UKSC 44 at paras. 29, 50, 114, 121.

> 'The preamble does not indicate more precisely what is meant by double taxation: in particular, whether the Convention is restricted to "juridical double taxation", or can also extend to "economic double taxation".'[30]

> '…there was no necessary implication that economic, as distinct from juridical, double taxation was not intended.'[31]

> '[The] liability to UK tax is therefore computed by reference to the same income as was taxed in the US. [Mr Anson] accordingly qualifies for [treaty] relief…'[32]

The position that tax treaties could accommodate different tax residents on the same income arose also in *HMRC v Smallwood*.[33] There the United Kingdom court of appeal found that tax treaty relief in cases of resident/resident-based attributions concerned itself '*only with the possibility of double tax charged on the same…[income], and not with the period of residence which gave rise to it'*.[34]

Lord Justice Patten finds:

> 'The question which this therefore raises (and critically in the present case) is how the [tax treaty] is intended to resolve residence/residence-based conflicts when the liability under the relevant domestic legislation does not depend upon concurrent periods of residence.'[35]

> 'There is no reason why the Treaty should not acknowledge it, without the need for the creation of the artificial deeming concept created by the Commissioners.'[36]

This statement indicates that it may arise that a resident/resident-based attribution can reasonably be expected to occur from the results of different domestic tax regimes, concluding:

> '[Tax treaties] must, I think, be construed as effective to deal with any liability to taxation…which either Contracting State may impose regardless of the basis of that charge under the domestic legislation in question… The definition of "resident of a Contracting State" in Article 4(1) reinforces this view by making "liability to taxation" by reason of residence the criterion for the taxation…This, I think, must denote what the Special Commissioners described as chargeability and not simply physical residence.'[37]

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[30] Ibid para 30.
[31] Ibid para 67.
[32] Ibid para 121.
[33] *HMRC v Smallwood* 2010 (EWCA Civ 778) EWCA Civ 778.
[34] Ibid paras 43-44. Although the final result dismissed the high court decision, the taxpayer applied the tax treaty to Mauritius income to which he was never resident. See comments by Philip Baker 'Smallwood - The High Court Decision' (2009) VIII.3 *GITC Review* at 16-17.
[35] *HMRC v Smallwood* supra note 33 at paras. 37 with whom Lord Justice Ward agrees at 72.1.
[36] Ibid at 34.
[37] Ibid at para. 40.

Unlike Treasury's view, the above discussion indicates that the same income rather than the same resident may be entitled to relief by way of tax treaties.[38] Thus, the question that makes the Treasury's view incomplete, is that an *'as if'* fiction may result in a resident/resident-based attribution. To this end, there can be seen divergent views as to the plain effect of *'as if'* as it arose in the cases of *Bricom* and *Fowler* respectively.

1.3. Research questions

For this minor dissertation, the question to be resolved is:

Is *'notional income'* that arises because of a statutory fiction the subject matter or not of South Africa's model-based bilateral income tax treaties?

To resolve this question, the following sub-questions are relevant:

1) Is the *'as if'* fiction notional income?
2) If the *'as if'* is not notional income, can the net income from CFC rules be reconciled to the rules of South Africa's model-based bilateral tax treaties?

1.4. Research method

This minor dissertation follows the ordinary rules of interpretation for legal interpretative research. The method is doctrinal, and the research is analytical. In an analytical approach, the technical details are compared against legal principles.[39] An analytical method prefers the functionality of legal theory so that the law is not confined to domestic nuances.[40]

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[38] Regarding the effect in tax treaties of the same income taxed by two different tax resident jurisdictions, see discussion in Chapter 4.4(a). For similar principles of fiscal transparency in South Africa, *Smallwood* supra note 33 was cited with approval in *Oceanic Trust Co Ltd No v CIR* 2011 (15) ITLR 172 (ZAWCHC), which dealt with tax treaties and trusts; and *J.J. Grundlingh v C.SARS* 2009 ZAFSHC 88 which dealt with tax treaties and partnerships.

[39] See Carlo Garbarino 'Comparative Taxation and Legal Theory: The Tax Design Case of the Transplant of General Anti-Avoidance Rules' (2010) 11.2 *Theoretical Inquiries in Law* 765 at 765.

[40] A similar example adapted in this research paper and regarding CFC rules appears in BJ Arnold 'A Comparative Perspective on the US Controlled Foreign Corporation Rules' (2012) 65 *Tax Law Review* 474 at 474.

The method is applied to the current drafting of South African CFC rules and the extent that these rules accord with the business profit article of South Africa's tax treaties in the hands of the South African resident shareholder. The primary legislation focusses the above ambit to select portions of section 9D of South Africa's Income Tax Act, 1962, and article 7(1) of South Africa's OECD based tax treaties.

Normative principles are derived from domestic and foreign cases. Foreign cases mainly refer to the United Kingdom, which are frequent sources of interpretative guidance in South Africa.[41]

In addition, the articles and commentary to the OECD bilateral model tax convention are used to formulate certain arguments. In this regard, literature relevant to the subject matter of CFCs and statutory construction is also used.

The OECD model tax convention (2017) applies as applicable.

1.5. Structure of chapters

This minor dissertation is divided into three additional chapters and a conclusion.

Chapter Two introduces the divergent effect of an *'as if'* fiction in the context of domestic tax law and tax treaties, by providing an alternative argument to the case of *Bricom* as it was found to be in the case of *Fowler.* A significant component of this chapter is also a critique to the findings of the *Bricom* decision.

Chapter Three details the theoretical effect of the *'as if'* fiction on the ordinary meaning of the fictional subject matter. It theorises that the plain meaning of *'as if'* suggests a full transfer of fictional identity from one subject matter to another – thus, the fictional income may be provided its full ordinary meaning. This effect is similar to statutory deeming.

Chapter Four consolidates the views from Chapters Two and Three in the form of a case study. It uses a hypothetical scenario of CFC 'sales income' and applies the methodology derived

[41] R. Carvalho & I. Daniels & M. Dewar et al 'Is there evidence of increasing harmonization in the interpretation of tax treaties by courts in their reference to foreign court decisions? A study of South African case law' (2017) 10(71) *Bulletin for International Taxation* at 1.2-1.4.

from the former Chapters to CFC rules and Article 7(1) of South Africa's model-based tax treaties. The Chapter is in the vein of three alternative fact patterns introduced by the *'as if'* fiction. In particular, the objective is to determine whether the income treatment in section 9D of the Act for resident/resident-based attributions conflicts with tax treaties. In concluding, the Chapter looks at the effect of CFC rules like transparent entities, and the tax 'saving' clause.

Last, a conclusion follows.

1.6. Limitations

This minor dissertation does not intend to conclude on section 9D and the application of tax treaties to it specifically. The *'as if'* concept appearing in section 9D is used as an example to illustrate the difficulty that has arisen in the construction of these words and the resulting effect in tax treaties. The interaction between the *'as if'* concept in the context of all wording in section 9D(2A) is not assessed in detail. Assessment of factual exemption of section 9D is omitted.

This minor dissertation proceeds on the characterisation of the underlying income limited to Article 7(1) as detailed in Chapter Four.

The conclusion that a CFC regime may constitute an 'anti-avoidance' rule is not established in this minor dissertation.[42] It does not appear that the objective to fight against tax avoidance or evasion permits an immediate exception to the distributive provisions of tax treaties.[43] The prevention of tax avoidance does not itself justify an interpretation that goes against the terms of such provisions.[44] Avoidance is a factual assessment that must be proven.[45] A test of avoidance is thus intentionally omitted and beyond the scope of this minor dissertation.

[42] See OECD, *Designing Effective Controlled Foreign Company Rules, Action 3 - 2015 Final Report* (OECD Publishing 2015) at 30 para 60. In South Africa - Davis Tax Committee op cit note 22 at 21 para 3.
[43] *Re Société Schneider Electric* 2002 4 ITLR 1077 (Conseil d'Etat (French Supreme Administrative Court)) ; L. De Broe, *International Tax Planning and Prevention of Abuse* (IBFD 2007) at 63.
[44] *Sasol Oil v C.SARS* 2018 923/2017 (ZASCA 153) paras 60-61, 124-127.
[45] Ibid paras 91-93.

CHAPTER TWO – THE CONTRASTING VIEW TO THE NOTIONAL EFFECT OF THE *'AS IF'* FICTION ON DOMESTIC TAXABLE INCOME

2.1. Introduction

This Chapter provides a detailed contrast to the cases of *Bricom* and *Fowler* respectively to indicate the opposing effect that the construction of *'as if'* has in domestic tax law. On the one hand, the *'as if'* represented a notional definition in *Bricom*, and on the other, the *'as if'* represented a deeming rule in *Fowler*. As a note, this Chapter also makes the occasional reference to tax treaties, although the focus is only illustrative; Chapter Four looks at the effect of tax treaties in detail.

Additionally, because South Africa adopted the *'as if'* fiction following the *Bricom* case, this chapter looks at the *notional* result in that case. Unlike *Bricom*, however, this chapter also considers that an *'as if'* fiction may have an alternative meaning with a taxable identity that is not necessarily notional – a finding that arose from the *Fowler* case. These aspects are explained.

2.2. The meaning of *'as if'* in South African CFC rules

In 2000, South Africa adopted a full CFC regime in section 9D of the South African Income Tax (the Act).[46] The purpose was to tax the income owned by South African residents of foreign resident corporations in order to prevent tax deferral.[47] There were, however, some drafting difficulties as tax treaties already acknowledged the corporate veil of foreign resident corporations.[48]

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[46] Act, 58 of 1962; Section 9D(2) of the Act, substituted with 9D(2A) with Taxation Laws Amendment Act, No. 30 of 2000 and Revenue Laws Amendment Act, No. 59 of 2000; Oguttu, op cit note 14 at 103.
[47] See Treasury op cit note 23 at 1. *Deferral* (also used with terms such as *diversion*) has generally been seen to be the use of a lower tax jurisdiction to reduce the effective rate of taxation by delaying or eliminating the tax assessment in the jurisdiction with the higher rate - see Michael J. Graetz *Foundations of International Taxation* (Foundation Press 2003) 217-8 ; Alexander Rust 'CFC Legislation and EC Law' (2008) 36(11) *Intertax* 492 at 492.
[48] See for example, the definition of *person* in Article 3(1)(a) which defines a person as an individual, company or any other body of person – OECD, *Model Tax Convention on Income and on Capital* (2017).

To align with tax treaties, South Africa could not directly tax foreign corporations on their foreign sourced income as the corporation itself had no direct taxing nexus to South Africa, even if South African residents had complete ownership of them.[49] To remedy the problems associated with deferral, South Africa adopted a CFC regime that taxes the South African owners on their foreign income of their foreign entities as if those foreign entities immediately repatriated their foreign income when earned.[50]

The former section 9C and the initial section 9D, repealed after the 9D update, were both legislated in the Act in 1997 and included deemed source rules for investment income to be taxable in the hands of the South African tax resident.[51] In tax treaties, however, the result was not as settled. The direct taxation of the actual income of a CFC did not change the nature of that income, and thus, tax treaties may have rendered ineffective the sourcing rules as the same amount from the CFC was being taxed twice.[52] This inefficiency was because tax treaties may have provided relief from the double taxation that arose based on the same income being taxed twice, and relieved the tax that was levied in CFC rules.[53]

To effectuate the CFC methodology without the above position, the actual income in the foreign corporation and the tax on an amount based on that income had to be separated by way of a domestic statutory fiction. The fiction substituted an amount of actual CFC income with an amount of income without a discernible identity. The mechanics of this logic arose from the wording replicated from the decision of *Bricom* in the United Kingdom court of appeal.[54] Of importance were the terms *'equal to'* and *'as if'* emerging from that case, the most significant of which was the effect of *'as if'*.

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[49] Treasury op cit note 23 at 1.
[50] Ibid.
[51] See Tickle op cit note 21 at 664, both *investment income* (generally passive income) and *resident* was defined in section 9C ; Annet Wanyana Oguttu 'Ensuring a right balance in applying the residence and source bases of taxation', 'Controlled foreign company provisions' in Johann Hattingh & Jennifer Roeleveld & Craig West, *Income Tax in South Africa – the first 100 years 1914 to 2014* (Juta 2016) at 258-9.
[52] See for example, Oguttu, op cit note 14 at 103. The former 9D(2) had a direct basis of taxation on the same CFC's actual income, stating:

> 'There shall be included in the income of any resident contemplated in the definition of a 'controlled foreign entity' in subsection (1), a proportional amount of any investment income received by or accrued to such entity.'

[53] Oguttu in ibid at 102 stating relief from so called 'economic double taxation'. See more recently, the cases of *Anson* supra note 29 and *Smallwood* supra note 33 referred to in Chapter 1.2 of this minor dissertation.
[54] *Bricom* supra note 7.

The *Bricom* case found that the terms *'equal to'* was a calculation based on an *'as if'* definition, that was defined notionally.[55] That is, that the actual income was not the subject of the tax, but rather, an amount based on the actual income – a product of artificial calculation.[56] The *'as if'*, was not, therefore, the same income of the CFC.

The tax resulting from that calculation meant that it represented what was termed a *notional* measure against the CFC's actual income but did not tax it.[57] Thus, 'the income' and the tax on 'an amount based on that income' were distinctive concepts created and introduced by the *'as if'* statutory fiction. The terms *'equal to'* represented the tax calculation on a notional definition that had no identity to the CFC's actual 'income'.[58]

The result of the above was that the notional sum calculated was no longer included in the scope of tax treaties because, while tax treaties could limit the actual taxation of the income itself, tax treaties did not scope in the tax on an amount based on that income.[59] South Africa's regime, therefore, followed a similar pattern.

The above effect can be seen in the current definition of *'net income'* as it exists today in section 9D(2A) of the Act.[60] *'Net income'* is defined as the taxable income for the shareholder of the CFC as:

> '…an amount *equal to* the taxable income of that company determined in accordance with the provisions of this Act *as if* that controlled foreign company had been a taxpayer, and *as if* that company had been a resident for purposes of the definition of 'gross income''[61] [*emphasis added*]

There appear two *'as if'* fictions to be given effect. In the *Bricom* view, these are notional definitions, which means they are based on assumptions of actual fact and actual income, but are not the tax on the actual fact and actual income itself. The first fiction is that the CFC is a taxpayer (notionally defined). The other is that the CFC is tax resident for the purposes of gross income – that is, the CFC has taxable income attributed to the resident shareholder (again, notionally defined).

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[55] Ibid at 379.
[56] Ibid.
[57] Ibid.
[58] Ibid at 376.
[59] Ibid at 376-7.
[60] Ibid.
[61] Ibid.

Notably, the drafting technique in the above definition has a certain silence as to the nature of the actual income of the CFC and the effect of that amount for the shareholder. This is because the net income is an incomplete definition – meaning, that it simply provides the charging provision to scope in the taxable income of the CFC for the resident shareholder. This, however, necessitates determining what the net income of the CFC is – by referring to the CFC's actual results and calculating the tax based on that income in the Act.

Of critical importance, however, is the distinction in concept of *actual income* and *notionally defined income* arising from the *'as if'* fiction. The notional definition represents a tax on what has been earned or generated by the CFC but as a notional amount of taxable income for the shareholder. This is unrelated to the actual income of the CFC.

This means that the shareholder's taxable income is determined with reference to any CFC it holds and the amount is calculated with reference to the CFC's actual income in the same way as a South African resident taxpayer, that is, the net amount remaining after any deductions against gross income including deemed amounts, although that amount itself is notional.[62]

From the above, the significance of the *'as if'* as a notional statutory fiction so emerges, in order to produce the result that CFC rules are unaffected by tax treaties.

In 2018, however, a contrasting theme which was developed from the case of *Fowler* considered the effect of the *'as if'* as a deeming rule. If an *'as if'* fiction is regarded as a deeming rule – it will negate the very concept of notionally defined income. The result is that the same income of the CFC is taxed on a world-wide basis without an intermediate step in the form of a third-party act, analogous to the declaration of a dividend from the CFC.[63] This means that

[62] The Act supra note 46 section 1 'gross income', 'income', 'taxable income'.
[63] *Anson* supra note 29 at 41. To further the argument, note at 31, 114, and 121, the Anson case had to determine the effect of *'computed by reference to the same profits or income'* of a United Kingdom member of a United States (US) Limited Liability Company (LLC). The principle arising from that result found that a United Kingdom tax computed for a United Kingdom tax resident, determined by reference to income taxed in a United States LLC, hinged on the term *'the same'*. The court found that there was no dispute that the income that was taxed in the US was the member's share of the profit of the LLC, even without receiving a transfer of profit. The liability to UK tax for the member was therefore computed by reference to the same income as was taxed in the US. It is submitted that a computation with the term 'equal to' may have a similar effect to the court's reasoning of the term 'the same'. A 'deeming' rule may therefore result in the CFC or its actual income being taxed. A further analysis of the term 'equal to' or this comparison is, however, not included in the scope of this minor dissertation.

the shareholder is taxed, depending on what the CFC's *net income* is, directly on the actual 'income' of the CFC.[64]

In addition, when the same CFC's income is taxed twice on a worldwide basis on two different tax residents, a resident/resident-based attribution may occur.[65] In the case that tax treaties may apply to resident/resident-based attributions, tax treaties have their own sourcing rules and will attribute the amount of income through the distributive rules of tax treaties in order to determine how that amount will be taxed between the two contracting states.[66] These views are expanded on in Chapters Three and Four, but the contrasting concept is that the effect of *'as if'* may be regarded as both a notional rule or a deeming rule, the latter with significantly more complex results in tax treaties.

This contrasting effect is explained below.

2.3. The contrasting effect of *'as if'* from the definition of *'net income'*

In 2002, National Treasury issued a detailed explanatory memorandum to CFC rules to explain the update.[67] It begins with a simple fact pattern to indicate the method of attribution based on the CFC's *'net income'*.[68]

The example is that a South African resident holds the CFC's shares. The resident transfers cash to buy bonds in the CFC. The only income generated in the CFC amounts to R100 of interest, which is reinvested by the CFC. Treasury states that section 9D does not tax the foreign entity on its R100 of interest, but taxes the South African resident *'as if'* it earned R100 of a *'revenue nature'*.[69]

It appears that this follows the *Bricom* effect in that the *'as if'* derogates from the identity of interest itself and assumes no identity. The logical corollary of the effect of the fiction in this

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[64] Ibid. Note that although the Fowler case did not deal with attributed income, that is, CFC income, the contrasting result in Fowler is used to illustrate the issue underlying the words 'as if', and the contrasting effect in tax treaties.
[65] See Chapter 1.2. *Anson* supra note 29.
[66] Anson, ibid at 98.
[67] Treasury op cit note 21 at 1-2.
[68] Ibid.
[69] Ibid.

definition is that the resident shareholder taxpayer is taxed on R100 calculated based on interest, but is not interest itself. That is, the tax is on an amount defined notionally by reference to the term *'as if'*.

If the *'as if'* is not seen to be defining a notional amount, the product of the calculation is therefore not also a notional product. This follows from the basis that the amount taxed has the same identity as what is computed from the CFC. Using the contrasting view in *Fowler* means that the income taxed in the above example is an amount of interest income calculated in South Africa but attributed from the CFC. Thus, the amount of R100 taxable income represents R100 of taxable interest taxed for the shareholder as it is earned by the CFC.

The contrasting view as to how the *'as if'* may support a notional and deeming rule, respectively, is explained below.

2.4. The meaning of *'as if'* in the *Bricom* case

The *Bricom* case dealt with a Dutch CFC controlled by United Kingdom resident shareholders. CFC rules appeared in section 747(4)(a) of the United Kingdom Act (the United Kingdom Act) and stated:

> 'a sum equal to corporation tax…on that apportioned amount of profits…of a controlled foreign company…shall be assessed…from the resident company as if it were an amount of corporation tax chargeable on that company'[70]

The 1980 United Kingdom-Netherlands tax treaty stated:

> 'interest arising in one of the States which is derived and beneficially owned by a resident of the other State shall be taxable only in that other State.'[71,72]

'*Profits'*, as above, were calculated based on various assumptions that referred back to the United Kingdom Income Tax Act.[73] Like South Africa, the most significant assumption being that the chargeable *'profits'* were determined on the basis that the CFC was tax resident in the United Kingdom.

[70] *Bricom* supra note 7 at 371.
[71] Ibid.
[72] The wording of the interest Article was the same as that of Article 11 of the OECD Model Tax Convention (2017).
[73] Schedule 4, Income and Corporation Taxes Act, 1988 (United Kingdom Act).

Bricom Group Limited (BGL), a corporation resident in the United Kingdom, had a wholly owned CFC in the Netherlands, Spinneys. The only material income in Spinneys was interest on a loan advanced to BGL, which was taxed as such in the Netherlands. Tax assessments were issued to BGL on the *'profits'* of Spinneys based on British CFC rules.

From the above definition, British CFC rules taxed an amount *'equal to'* the profits of the Dutch CFC and '*as if*' it was an amount chargeable as corporation tax for the resident of the United Kingdom.[74]

The taxpayers argument surrounded the assumption that the residence of the CFC in calculating the CFC charge, meant that the same CFC's income was taxed in the United Kingdom. For tax treaty purposes, that argument was that it also had the effect that the CFC was taxed as a dual resident.[75] BGL, therefore, appealed the assessments on the basis that *'profits'* represented the interest income of Spinneys that was already taxed in the Netherlands. In addition, the tax treaty with the Netherlands exempted interest from tax in the United Kingdom.

In the court of appeal there were two questions. The first was whether or not the amount taxed by British CFC rules on the *'as if'* assumptions was the same CFC income exempted by way of the tax treaty? The second was if the CFC charge was a corporation tax?

2.4.1. Was it the same income?

In the United Kingdom, CFC rules appeared in section 747(4)(a) of the United Kingdom Act, and for which Section 754(2) stated:

> 'For the purposes of the Taxes Act, any sum assessable and recoverable under section 747(4)(a) shall be regarded as a corporation tax…'[76]

[74] *Bricom* supra note 7 at 376, section 747(4)(a) United Kingdom Act supra note 73.
[75] *Bricom* in ibid at 374.
[76] Section 754(2) supra note 73.

Section 788(3) of the United Kingdom Act provided that tax treaty relief was available to *'income tax and corporation tax'*.[77] BGL held that the tax charge therefore fell directly into tax treaties on the basis that the CFC calculation was ordinary corporation tax defined in the Act.[78]

Initially, BGL appealed the tax assessments before the Special Commissioners on the basis that calculation meant that the CFC's income had the same identity to the profits of the CFC.[79] The Commissioners, however, found that a CFC rule was not a corporation tax, but a tax similar to it – '*sui generis'*.[80] It was not, therefore, ordinary corporation tax, and not, therefore, a tax to which the tax treaty applied.[81]

The Commissioners supported that finding with the domestic decision of *Joint v Bracken Developments Ltd* which had the terms *'equal to'* and *'as if'* similar in terminology to CFC rules.[82] The Commissioners held that the case was an illustration that these terms necessarily implied that it was not a corporation tax and the income calculated had no identity.[83] Thus, that income lost it identity for tax treaty purposes.[84]

Bracken Developments Ltd dealt with interest on loans to members of private companies. The then section 419 of the Taxes Management Act, 1970, stated that:

> 'there shall be assessed on and recoverable from the company, as if it were an amount to corporation tax'; and
>
> 'an amount equal to such proportion of the amount of the loan or advance as it corresponds to the rate of advance corporation tax in force…'[85]

In *Bracken Developments*, the manner that these two provisions integrated back into the Taxes Management Act was silent, and so the question was whether or not the amount of interest

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[77] *Bricom* supra note 7 at 373.
[78] In South Africa, tax treaties are given effect as if they formed part of the Act in section 108(1) of the Act read with 231(2) of the Constitution of South Africa, Act 108, 1996. There is, therefore, a similar view that tax treaties may cover all taxes arising in the Act, see header 2.7 below.
[79] *Bricom* supra note 7 at 373.
[80] Ibid.
[81] Ibid.
[82] *Joint v Bracken Developments Ltd.* 1994 STC 300 (ChD) at 237.
[83] *Bricom* supra note 7 at 373.
[84] Ibid.
[85] Section 419 of the Taxes Management Act, 1970 (United Kingdom).

from this provision was also interest that could be deducted by the company elsewhere in the Act?

In that case, Vinelott J. found it was not, because the provision replaced corporation tax with a charge under that section.[86] The case also referred to the earlier decision in *Earlspring Properties Ltd. v Guest,* where Vinelott J. reached the same conclusion,[87] resolving:

> 'Although it is to be an amount corresponding to the rate of advance corporation tax, it is not itself advance corporation tax'[88]

Thus, it was not itself corporation tax. The above finding was clearly a distinct fact pattern that may be distinguished from CFC rules, which already had a provision that stated that a CFC charge was corporation tax, as above. That, in effect, meant that the calculation of the CFC rule subjected the same CFC's income to ordinary corporation tax on the basis it was taxable income in the Act for the resident corporation. BGL therefore appealed and the question, therefore, rearose in the court of appeal.

The court of appeal approached the points of appeal separately. That is, it first dealt with whether or not it was the same income as the CFC for tax treaty purposes, and second, whether or not it was a corporation tax. The court eventually dismissed the first point of appeal, leaving the second unanswered.

On the second point, the court reflected briefly on the Commissioners findings in an opening remark. That is, the court stated that, were the Commissioners correct in the assessment that no tax treaty relief was available to corporation tax, the United Kingdom was in breach of the Treaty in not giving effect to it under domestic law.[89]

There Millet L. stated that there was force to the taxpayer's argument that section 754(2) (which treated the CFC charge as corporation tax) was not given full effect.[90] This can be seen in the finding that:

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[86] *Joint v Bracken Developments Ltd.* at 311.
[87] Ibid at 485.
[88] *Earlspring Properties Ltd. v Guest* 1993 STC 473 (ChD) at 310.
[89] *Bricom* supra note 7 at 373.
[90] Ibid at 379.

> …[T]he Special Commissioners…held that the interest lost its character…I do not regard that as an accurate description of the statutory process…[91]

Millet L., however, proceeded to agree that the Commissioners were correct to dismiss the taxpayer's appeal, but for a very different reason. It found that the income character was not lost as interest, but simply, the CFC's *actual income* was not included in the apportioned profits chargeable in CFC rules at all.[92]

Millett L. held that the use of the *'as if'* fiction introduced a hypothetical aspect to the *'profits'*, the assumptions of which were self-evident in that they were notionally defined.[93] Millett L. found that the reason why CFC rules would have been drafted on fictional assumptions, one being that the CFC was a resident, was that a non-resident would not normally be subject to tax in the United Kingdom; this represented a purely a hypothetical basis of residence.[94]

The definition of *'profits'* in that context was, therefore, also purely hypothetical.[95] That is, because the assumptions were counter factual, they arose only by substituting actual facts with fictional assumptions.[96] They were not, therefore, additional assumptions that were determined on the CFC's actual profits. Rather, the facts to which the CFC profits applied substituted fact for fiction.[97] The tax was therefore a product of an artificial calculation with the result that the amount was a purely notional sum.[98]

With reference to the actual CFC income, the court found that it was common ground that the interest paid to Spinney's from BGL was the interest which was taxed in the Netherlands; the tax treaty exempted that income from being taxable in the United Kingdom.[99] For the purposes of the CFC calculation, the 'interest' in the CFC rule was not the actual 'interest' from the CFC. It did not, therefore, have an identity of income for tax treaty purposes with the CFC.

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[91] Ibid.
[92] Ibid.
[93] Ibid at 375.
[94] Ibid at 376.
[95] Ibid.
[96] Ibid at 375.
[97] Ibid.
[98] Ibid at 376.
[99] Ibid at 369.

To justify the above argument, the court had to disregard the provision that stated that a sum assessable under CFC rules was regarded as corporation tax, which was a materially significant provision for tax treaty purposes. The first was that ‘any sum assessable’ in CFC rules was corporation tax.[100] The effect of the calculation took the same amount in the CFC, which was not taxable, and created taxable income in the United Kingdom.

The second point was that the provision which incorporated tax treaties into the United Kingdom’s tax law stated that tax treaties provided relief from double taxation on ‘corporation tax’.[101] Since a CFC charge was regarded as corporation tax, after it was calculated, it openly conflicted with the same provision which gave effect to tax treaties.

The net effect of not giving effect to it was that it unilaterally swapped tax-exempt interest by way of the tax treaty, for United Kingdom taxable income. Additionally, because whatever the *‘as if’* assumptions defined was also ordinary corporation tax, which gave effect to the fiction in the United Kingdom Act, there was never a distinction that the *‘as if’* was not the same income as that of the CFC.

2.4.2. Was the *‘as if’* notional income?

The question regarding the aspect of how *‘as if’* produced a *‘notional’* sum did not appear in the wording of the CFC legislation. That reference did appear in the CFC draft proposal in the November 1981 consultative document that used the term.[102] The *‘notional’* reference in the draft version may attest to an interpretative ambiguity being included in the drafting of CFC rules since its adoption, and the court’s finding to that effect.[103]

The draft did not match the CFC legislation that was eventually adopted.[104] The proposal to adopt CFC legislation in the United Kingdom 1983 Finance Bill stated:

> ‘Where, on such an apportionment of a controlled foreign company’s notional United Kingdom tax…an amount of notional tax is apportioned to a company resident in the United Kingdom

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[100] Ibid at 373 referring to Section 754(2) supra note 73.
[101] Ibid referring to Section 788(3).
[102] Board of Inland Revenue, *Tax Havens and the Corporate Sector* 1981, and Board of Inland Revenue, *Taxation of International Business* 1982 clause 1(4) of the Draft Clauses and Schedules on Controlled Foreign Companies, both in Sandler *CFC Legislation and Tax Treaties* op cit note 15 at 211.
[103] Ibid at 158.
[104] Ibid at 211.

> then… that apportioned amount of notional tax shall be assessed on and recoverable from the resident company as if it were an amount of corporation tax chargeable on the company.'[105]

From that wording, *'as if'* simply represented the plain language as to how the tax was attributed and collected from the resident, on the basis the amount was already a *'notional tax'*. That is, that a CFC tax was a notional tax (in source and in character) but the method of assessment and recovery from the shareholder was equivalent to corporation tax. A similar proposition was resubmitted in 1982.[106]

In 1983, however, the CFC proposal underwent a redraft for inclusion in the 1984 Finance Bill. When it was published, the Act had a significant change to the basis of how the income of a CFC was to be taxed. It stated that the charge to tax on CFC rules was an amount based on an apportionment of the chargeable profits of the CFC, but it excluded the reference to the term '*notional'*.[107] The 1988 Act, unlike the proposals, stated:

> '…a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits, less the portion of the controlled foreign company's creditable tax for that period (if any) which is apportioned to the resident company, shall be assessed on and recoverable from the resident company as if it were an amount of corporation tax chargeable on that company...'[108]

This provision indicated that the amount of corporation tax was determined based on the direct apportionment of CFC profits. It also stated that the CFC's taxable income was an amount of corporation tax that was calculated in accordance with the Act. This directly contrasted the concept of *'notional'* as it appeared in the draft proposal.

The decision in *Bricom* that the use of the statutory language *'as if'* was notional, therefore, appeared to revert to the logic provided by the statutory wording of the 1981 draft proposals.[109]

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[105] Ibid.
[106] Ibid.
[107] Ibid at 212.
[108] Section 747(4)(a) supra note 43.
[109] The question as to whether or not extra-textual sources of law would be permitted in South Africa is a question of its own. It is generally accepted that legal consequences must be embedded in the written fundamental law and the departure from the plain text can be considered as context. See *Natal Joint Municipal Pension Fund v Endumeni Municipality* 2012 (4) SA 593 (ZASCA 13) para. 18-19 where the words must be regarded with reference to their context with neither one prevailing over the other. See Davis Tax Committee op cit note 22 at 6 point 4 which states that 'explanatory memoranda have no legal effect'. See also *R v Vayi* 1946 NPD 792 where a court held that the words of a provision should not be interpreted as *ultra vires* (without effect) and *Ex Parte the Minister of Justice: In re R v Jacobson and Levy* 1931 AD 466 where it held 'the purpose of the legislation should not be defeated merely because the wording is vague or obscure', both in Christo Botha *Statutory Interpretation – An introduction For Students* vol 5 (Juta Law Books 2012) at 73. See generally Klaasen A *'Constitutional interpretation in the so-called 'hard cases' Revisiting S v Makwanyane'* (2017) at 8, questioning what is

That contrasting result, however, may have disregarded the two essential components which gave effect to the CFC rules as they stood in the 1988 Act, which may have been the logic of the taxpayer's submission when the case was heard.

The first stage was *'a sum equal to corporation tax at the appropriate rate on that apportioned amount of profits'*. The second stage was *'as if it were an amount of corporation tax chargeable on that company'*. From the plain language, it did not appear to be clear that computing the CFC's profits for the resident company *'on that apportioned amount'* had any change on the underlying character of income or the nature of the income in the CFC. This reference was simply that the amount calculated above was an amount of corporation tax for the United Kingdom resident. To calculate the amount, the *'as if'* fiction determined that basis by referencing to the hypothetical assumptions included in the Act. Those assumptions effectively brought the same income of the CFC into the Act as taxable income for the resident shareholder taxpayer.

The taxpayer's submission, therefore, followed this logic in the argument that the amount of profits must have been an amount of CFC profits, and, if the profits were that of the CFC, so was the sum which is apportioned to the taxpayer on which the tax is charged.[110] This, in effect, simply supplemented the resident corporations tax liability with that of the CFC's income.

The taxpayer's submission was certainly a logical argument that the deeming effect of calculating an amount based on the *'as if'* assumption was not notional. The effect of the statutory language was therefore, not a clear indication that the character of the amount computed was lost in this process and neither that the fictional assumptions resulted in a purely notional sum.

2.4.3. The interaction with tax treaties

On the finding of notionally defined income, the question in tax treaties was rather limited. Bearing in mind that the notional income already overrode the provision that a sum assessable

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permissible context, and at 10, on how to derive the meaning of terms. Available: http://www.saflii.org/za/journals/DEJURE/2017/2.pdf, last accessed 30 June 2019.

[110] *Bricom* supra note 7 at 376-7.

under CFC rules was corporation tax, and that tax treaty relief was available in domestic law on corporation tax. The above findings were confirmed in the court's unanimous view that:

> '[A] Double Taxation Agreement can enure for the benefit of a third party…This would support the…present case if the rules deemed the income to be the income of the taxpayer…'[111]
>
> '[B]ut where tax is charged on a conventional or notional sum which exists only as the product of a calculation, the fact that one of the elements in the calculation is measured by reference to the amount of exempted income does not make the exempted income the subject of the tax.'[112]

The result was that the question of 'real residence' of the CFC for tax treaty purposes, and the question of its actual income, simply fell away.[113]

The *Bricom* judgment brought about widespread criticism from commentators.[114] Many criticised the court's approach on the limited discussion surrounding the relevant tax treaty provisions on the basis the tax was in fact ordinary corporation tax, and, the finding that the Dutch entity's 'profits' may not be 'notional' in that regard.[115] Certain commentators found that the decision was wrongly decided.[116]

In looking at the plain effect of the wording, the expressions *'equal to'* and *'as if'*, merely calculated the amount of corporation tax payable in addition to any other sums payable by the company being assessed. The purpose and effect of CFC rules simply substituted the resident taxpayer with CFC's income, that substitution had no change on the actual income. In this way, commentators have stated that it not convincing that the CFC's taxable income is on the one hand, a notional sum, and yet on the other hand, has the same effect as any corporation tax.[117] From the above, the *Bricom* decision is, therefore, not unanimously shared by commentators as above, or by courts for that matter.[118]

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[111] *Bricom* supra note 7 at 377.
[112] Ibid at 378.
[113] Ibid at 376.
[114] M. Ullah 'National Report United Kingdom' in Michael Lang (eds) & Hans-Jorgen Aigner (eds) & Ulrich Scheuerle (eds) et al *CFC Legislation, Tax Treaties and EC Law* vol 8 (Kluwer Law International 2003) at 623-34; Philip Baker 'Editor's Note' in *Schneider* supra note 43 at 1078 ; De Broe op cit note 43 para 373; Daniel Sandler 'Tax Treaties and Controlled Foreign Company Legislation' (1998) 1 *British Tax Review 52* at 58; Philip Baker 'Editor's Note' in *Bricom* supra note 7 at 366-7.
[115] Ullah in ibid at 623, Sandler in ibid.
[116] Philip Baker 'Editor's Note' in *Bricom* supra note 7 at 366-7.
[117] Ullah op cit note 114 at 620; Sandler op cit note 114 at 58.
[118] The French Supreme Administrative Court case found the direct opposite in *Schneider* supra note 43 discussed in Chapter 4.5(b) below.

2.5. Summary of the *Bricom* findings

From the *Bricom* decision, it may appear to be an unusual result that the tax arising on an amount based on actual income is not also the same actual income that is taxable. The finding was that the concept of '*notional'* meant that the *'income'* could not be traced back to the same identity of the CFC.[119] Thus, no part of the calculation of the definition of the CFC's income arising from CFC rules could be attributable to any source.[120] It could not, therefore, fall into tax treaties because the tax was not a tax on income that could be seen to be the state of the CFC.

There appears to be no other authority that deals with that issue directly. That is, whether the tax on income and the tax on an amount based on that income are separate concepts. The relationship between the income and the taxable amount based on that income was not dealt with in any detail by the court of appeal in the *Bricom* case. It also appeared to be incomplete because that finding had to disregard the reference to a CFC rule being regarded as corporation tax.

Interestingly, the court of appeal held that the above view was not absolute in the sense that tax treaties could enure for the benefit of a third part in the event that '[CFC] rules deemed the income to be the income of the taxpayer'.[121] The question in that view is whether or not the effect of the *'as if'* was any different to the effect of a deeming rule?[122] This view is discussed next.

2.6. The meaning of *'as if'* in the *Fowler* case

It was quite by chance that the *Fowler* decision came across a similar question and had to deal with the *'as if'* fiction at the level of the court of appeal in 2018.[123] The result is diametrically opposed to the *Bricom* decision. The case determined that the *'as if'* may result in a deeming

[119] Ullah op cit note 114 at 619-620 at b) quote 5.1.5.
[120] Ibid.
[121] *Bricom* supra note 7 at 377.
[122] See the opposite view of the Canadian Supreme Court in *R. v Melford Developments Inc* 1982 (2) SCR 504 at 509-12 where His Lordship Etsy J. found that interest deemed to be something else does not lose its exempt tax treaty status or thereby allow Canada to tax it.
[123] *Fowler* supra note 16.

rule, such that the tax on income and the tax based on that amount were not separate concepts. In the context of CFC rules, it is submitted that this may mean that it is an amount of the CFC's actual profits and not a notional amount based on those profits that is taxed for the shareholder. This is discussed below.

2.6.1. The tax based on an amount and the income itself are one and the same

In the facts of the case, Mr Fowler was a South African tax resident. A tax assessment was issued to him on the basis of his employment income rendered in the North Sea of the United Kingdom. The issue surrounded the effect of '*as if*' and *'treated as'* which emerged as a consequence of an earlier update to the statutory language to section 15(2) of the Income Tax (Trading and Other Income) Act.[124]

The *'as if'* issue was addressed as the main judgment in the court of appeal, but it was also a minority view. Lord Justice Lewison who delivered the address did not have to deal with the issue at all because the *'as if'* reference did not appear in the statutory provision to be considered. Instead, Lewison LJ referred to the effect of *'as if'* in making the claim that the law did not change from the former drafting of the provision.

In 2005, the provision in dispute stated:

> '… [t]he performance of the duties of employment is instead treated for income tax purposes as the carrying on of a trade in the United Kingdom'[125]

The same section in 2003, before it underwent a rewrite, stated:

> '… the Income Tax Acts shall have effect as if the performance by that person of those duties constituted the carrying on by him of a trade …'[126]

Mr. Fowler, therefore, appealed the assessments to the first tier tribunal on the grounds that the income was income from a trade, which was also how the United Kingdom domestic law had taxed it.

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[124] Abbreviated 'ITTOIA', 2005.
[125] Section 15(2), Ibid.
[126] Section 15(2), ITTOIA, 2003.

The first tier tribunal accepted Fowler's submission that the income was trade. By doing so, the tribunal also rejected the submission of the counsel for the tax authorities. The argument raised by counsel for the tax authorities was a similar theme to the *Bricom* analogy – that is, the argument that separated 'what was taxed was employment income, and how it was taxed was as trade' were necessarily distinct concepts.[127]

In concluding, however, Judge Guy Brannan of the first tier tribunal rejected the submission that the meaning of a term and the tax treatment were separate concepts, finding that what gave rise to the tax charge was the meaning and not only a treatment for tax purposes.[128] By deduction, the income and the tax treatment based on income were one and the same. It was, therefore, necessary not only to look to the tax treatment, but also to the meaning of that income or activity.[129] The first tier tribunal found in favour of Mr Fowler and the tax authorities appealed the decision to the upper tier tribunal.

The concepts of *'as if'* and *'notional'* proposition gained a considerable amount of attention the upper tier tribunal, without referring to the literal terminology. Honourable Marcus Smith referred to the separation of the 'income itself' from the 'tax that was charged based on an amount of that income' as the *'status'* and *'fruits derived from that status'* on the analogy that the two concepts were necessarily separable. That is, what was taxed on income was different to what was taxed on an amount based on that income.

Smith H. held that the *'status'* was employment, and what was taxed based on that status was employment income as the *'fruits'*.[130] The *fruits* that were taxed as 'trade' had no impact on the *status* of employment. Smith H., in dismissing Mr Fowler's appeal in favour of the tax authorities, noted that a fundamental error submitted by counsel for Mr Fowler was the claim that the nexus between 'employment' and 'employment income' was so close that they had to be read together.[131] The upper tribunal did not agree with Fowler's submission. The *status* and *fruits* could be separated, and thus, the tax on employment and the tax on employment income may be distinct concepts.

[127] *Martin Frederick Fowler v HMRC* 2015 UKFTT 234 (TC) at 63.
[128] Ibid at 112.
[129] Ibid.
[130] *HMRC v Martin Frederick Fowler* 2017 UKUT 0219 (TCC) at 53.
[131] Ibid at 61.

The upper tribunal, therefore, resolved that it was the status rather than the fruits that determined the basis of taxation in tax treaties, thus, it was employment (the status) and not employment income (notionally taxed as trade) that determined the scope of tax treaties. This argument was similar to the *'as if'* analogy adopted in the *Bricom* view in that the employment income had a notional definition as trade (no identity), and the status as employment did not change. Mr Fowler disagreed and appealed the decision to the court of appeal.

In the court of appeal the *'as if'* terminology was referred to directly. The leading judgement of Lord Justice Lewison held that from the 2003 provision, the tax rewrite in 2005 did not intend changing the law.[132] Lewison L.J. found that the effect of the fiction was not in doubt and generally was to be provided with the ordinary meaning of that fiction.[133] Additionally, Lewison L.J. stated that the *'as if'* as a fiction *'does not, for example, deem the employment itself to be the carrying on of a trade'*.[134] This was the same view as the *Bricom* case, in that the *'as if'* income was defined notionally. However, what was distinct from *Bricom* was that Lewison L.J still found that the *'as if'* income had to be constructed for tax treaty purposes.

Lewison L.J. referred to the 2003 drafting on the basis that the meaning of employment income did not change to a trade, but was computed *'as if'* it were a trade. Lewison L.J. thus held that the provision correctly taxed what was regarded as employment and how it was taxed was as a 'pretend' trade – a notional definition.[135] This view was supported by the terminological reference to *'as if'* that appeared in the explanatory note to the legislation, even though the 2005 legislation did not make use of it.[136] The weakness arising from that reasoning, as noted by commentators, was that the argument had to completely ignore the plain words *'is instead treated as'* in the 2005 provision.[137] The view of Lewison L.J., however, was on the basis that the 2003 provision indicated that what was taxed as employment was distinct to how it was taxed as employment income.[138]

The majority judgement provided by Lord Justice Henderson with whom Lord Justice Baker agreed, therefore dissented, and necessarily, reverted to the older statutory text to contextualise

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[132] *Fowler* supra note 16 para 27.
[133] Ibid para 20.
[134] Ibid para 28.
[135] Ibid.
[136] Ibid para 25.
[137] Avery Jones op cit note 17 at 391.
[138] *Fowler* supra note 16 at 2.

the view of Lewison L.J. The majority held that the terms '*as if*' or '*treated as'* had no discernible difference in the current context the words were used.[139] By giving effect to the wording as they currently stood, it replaced the older version and the income in question had to be treated as income from a deemed trade to be given effect.

The majority decision, therefore, agreed with the ordinary meaning provided by Mr Fowler's reasoning, that the provision under consideration constituted a deemed trade.[140] Henderson L.J. also concluded that this result would have been the *same* if the terms were *'as if'* rather than *'treated as'* were used.[141] Finding:

> 'It is not just a question of how Mr Fowler's employment income is to be taxed. Rather, it is the substitution of one (notional) source of taxable income for another (actual, but disregarded) source…The drafting technique employed in that section is different…but in my view the substance is the same. The Income Tax Acts are directed to have effect 'as if' the performance by the relevant person of the specified duties of his employment 'constituted the carrying on by him of a trade. The effect of this language was to create a deemed trade, which could not exist simultaneously with the taxpayer's actual employment…His earnings from his actual employment (or the relevant part of it) must now be regarded for all income tax purposes as receipts of the deemed trade, which go into a computation of his trading income derived from that trade.'[142]

Additionally, and in direct contrast to Millett L. in *Bricom*, Henderson L.J. found that the separation of *'what is taxed'* and *'how it was taxed'* was not a helpful distinction in the current context.[143]

On the contrary, Henderson L.J found that the effect of deeming creates a new and exclusive taxable subject matter.[144] The charge to tax on employment and the tax on employment income must be regarded for all income tax purposes as the carrying on of a deemed trade, which then go into the computation of trading income.[145] It was, therefore, not possible to separate an amount of income from the tax on that income.

Thus, the court resolved that the *'as if'* in the current drafting, created a deemed trade. Unlike *Bricom*, however, the contrast arising from *Fowler* was that the terms *'as if'* did not have a

[139] Ibid para 43.
[140] Ibid.
[141] Ibid.
[142] Ibid para 41-3.
[143] Ibid.
[144] Ibid.
[145] Ibid.

notional consequence. The effect of the *'as if'* in the *Fowler* context meant that employment became a trade and was taxed as a trade, rather than employment income being taxed based on a trade as a notional concept. In addition, it did not, therefore, separate a tax on actual income (employment) with a fictional amount of tax based on that income (trade) as distinct concepts. The fictional income and the tax on the fictional income were one and the same. The effect of fiction in *Fowler* therefore directly contrasts the proposition found in *Bricom*.

2.6.2. The interaction with tax treaties

A significant aspect to the court's reasoning was that the reference to *'for income tax purposes'* as it appeared in the provision, was 'clearly wide enough' to embrace tax treaties.[146] Thus, the domestic fictional income imported that meaning into tax treaties.[147] This was because tax treaties were enacted into domestic tax laws to be given effect by the tax arising in the United Kingdom. Additionally, the position in *Fowler* meant that the fiction of *'as if'* retained the fictional character in tax treaties.[148]

The above was a significant difference to the *Bricom* case – where the reference to *'shall be regarded as corporation tax'* was disregarded despite tax treaties giving relief to corporation tax.[149] The *Fowler* justification, is therefore, preferred as it gave effect to the statutory wording.

The *Fowler* case provides an indication that the effect of *'as if'* did not separate the income from the tax based on that income as separate concepts. On the contrary, the tax and the income were identical given that the plain effect of *'as if'* was synonymous to deeming rules. Applying this methodology of the *'as if'* to CFC rules, therefore, means the tax on the CFC's actual income and the tax on an amount based on that income are identical concepts.

2.7. A view that fictions are covered by tax treaties in South Africa

The view that all South African taxes, including fictions, are covered by tax treaties is similar to the *Fowler* case, which found that the reference to *'for income tax purposes'* meant that the

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[146] Ibid paras 40-42.
[147] Ibid.
[148] Ibid paras 40-43.
[149] See footnote 100.

tax arising from domestic fictions could generally be embraced by tax treaties.[150] In South Africa the interaction between tax treaties and the domestic tax laws are provided for in section 108(1) of the Income Tax Act.[151] Tax treaties are brought into operation and have the effect of law as if enacted into the Act.[152] The Supreme Court of Appeal has affirmed that from the articles of tax treaties, the contracted parties intended that all South African income tax would be dealt with in one or other of the articles of tax treaties.[153] This applies to 'normal tax', which includes the tax on capital gains.[154] A CFC rule is normal tax. Tax treaties, therefore, provide the rules that are to be reconciled from all normal tax arising from the Income Tax Act.[155]

The term 'income' is not defined in tax treaties.[156] That is because 'income' refers to the tax on income that arises in the domestic tax law of the contracting states.[157] In the South African Income Tax Act, 'income' can refer to anything that the Act says it is.[158] In some cases, the Act generates 'income' as a fiction, which is a purely legal construct. For example, a taxpayers change of residence.[159] There is nothing 'actual' about that 'income', and even the amount itself is nothing 'actual'.

The 'income' in tax treaties is, therefore, not actual either, because tax treaties apply to the same 'income' that has arisen as taxable 'income' in domestic tax law.[160] Tax treaties rely on the domestic taxing rules in order to apply to all domestic taxes levied on 'income', irrespective of how the income is determined in domestic law.[161] This effect means that tax treaties will treat the tax arising on fictional income the same as any other provision because the tax arising on that income is an actual tax charge the same as any other provision.[162]

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[150] *Fowler* supra note 16 paras 40-42.
[151] Act 58, 1962, section 108(1)-(2)
[152] Ibid.
[153] *C.SARS v Tradehold Limited* 2012 (4) SA 184 (ZASCA 61) at 22.
[154] Ibid.
[155] See C Cilliers, *SILKE on International Tax* (Lexis Nexis 2017) paras 46.2, 46.36.
[156] Modelled on 2017 OECD Model Tax Convention.
[157] Article 2(1), OECD, *Model Tax Convention on Income and on Capital* (2017).
[158] RC Williams 'Some missteps on South Africa's road to a coherent income tax jurisprudence' in Hattingh et al. op cite note 51 at 211-217 referring to the definition of *'gross income'* in section 1 of the Income Tax Act, 58, 1962.
[159] *Tradehold* supra note 153.
[160] See a similar discussion in Prof. Dr Michael Lang 'CFC Regulations and Double Tax Treaties' (2003) 57(2) *Bulletin for International Taxation* 51 at 53-54.
[161] See Article 2(1), OECD, *Model Tax Convention on Income and on Capital* (2017).
[162] *Tradehold* supra note 153.

2.8. Summary of Chapter Findings

This chapter highlights two different approaches to *'as if'* as determined by the above two cases. The 1997 *Bricom* decision resolved that the terms *'as if'* represented a fiction that was defined notionally and that measured an amount based on income, but was not the income itself. The term *'equal to'* follows the notional definition and indicated that it was not the same income but an amount calculated based on that notionally defined income.

The case itself does not appear to be clear on this justification, at least not from the definition that it was also defined to be ordinary corporation tax, which had to be ignored. The tax and the tax on an amount based on that income did not appear to be different. Critics also questioned the idea that the *notional sum* could be separate from the actual income.

The result, however, was that the 'income' in CFC rules was not the same income as that of the CFC, and secondly, not the actual income of the CFC. The aptly named *'notional'* sum so emerged, which meant that the amount calculated based on the CFC had no identity or character to the CFC's actual income. It was, therefore, not the same subject matter dealt with in tax treaties.

The opposite view of the *'as if'* as a deeming rule was derived in the *Fowler* decision in 2018. The view was unsupportive of the proposition that the income and the calculated amount of tax based on that income were capable of separation. The two could not exist as mutually exclusive concepts. This arose because the effect of deeming was to create a new and exclusive taxable subject matter such that the fiction substituted and replaced the actual facts. It was the new subject matter that was given effect for income tax purposes.

Adopting this methodology in CFC rules means that the effect of *'as if'* as a deeming rule directly taxes the same CFC's actual income and calculates the tax on that same income on the basis that the CFC's income is substituted for the South African shareholder. It could not then be a purely notional sum.

The effect of giving effect to fiction in domestic law may occur because in South Africa, tax treaties can accommodate fictions because tax treaties are given effect by a domestic tax charge and apply to similar taxes of any kind.

This chapter, therefore, determined that the income following an *'as if'* fiction was not necessarily notional when the effect is a deeming rule. The next chapter, therefore, looks at the meaning and effect of *'as if'* as a deeming rule more closely.

CHAPTER THREE – THE ORDINARY MEANING OF FICTIONAL 'INCOME' IN THE CONTEXT OF DOMESTIC TAX LAW AND TAX TREATIES

3.1. Introduction

This chapter builds on the findings of Chapter Two. A distinction arose in the *Bricom* and *Fowler* cases regarding the effect of *'as if'* as a notional fiction or a deeming rule respectively.

This chapter compares the theoretical view of the *'as if'* fiction to the ordinary meaning of fictional income from statutory deeming rules using select case law. The objective of this chapter is to generalise the view that an *'as if'* fiction may have a similar effect to deeming rules. The difference is simply a matter of expression of the term *'as if'*. This finding arises because the *'as if'* supports the full transfer of identity of one income to another, which is also the theoretical view conceived by *Vaihinger*.

3.2. The interpretation of fiction in *Bricom* and *Fowler*

From Chapter two, both the *Bricom* and *Fowler* cases had to construct the *'as if'* fiction. In *Bricom*, the effect was to calculate an amount of corporation tax based on fictional assumptions, including determining the amount based on the assumption that the CFC was regarded as tax resident in the United Kingdom. This can be seen in the below summary by Millett L.:

> 'It is critical to the taxpayer's argument that the assumption…that the company, which is ex hypothesi resident outside the United Kingdom…is also resident in the United Kingdom. I do not accept that proposition. The statutory assumption is ambiguous…In my judgment, the relevant assumption is that the company is instead resident in the United Kingdom.
>
> The scope of a deeming provision is a question of construction and is not subject to any special rule…A statutory hypothesis, no doubt, must not be carried further than the legislative purpose requires, but the extent to which it must be carried depends upon ascertaining what that purpose is.
>
> In the present case the purpose for which the assumptions are required is self-evident. As a non-resident, it will not normally be subject to United Kingdom corporation tax and will have made no claim to relief from such tax…The assumptions which [CFC rules] requires are not additional assumptions to be made in combination with the actual facts. In relation to the matters which they cover they are substituted for the actual facts. Spinneys was resident outside

> the United Kingdom; this means that it had no profits actually chargeable to corporation tax; accordingly its chargeable profits are to be ascertained on the footing that it was resident in the United Kingdom instead. …There is no question of real residence.'[163]
>
> 'What is apportioned to the taxpayer and subjected to tax is not Spinneys' actual profits but a notional sum which is the product of an artificial calculation.'[164]

From the above, Millett L. held that the domestic statutory fiction, *'as if'* could not co-exist with the actual facts. Millett L., therefore, disregarded the full effect of the fictional assumptions on the basis that those assumptions did not replace the actual facts. The fictional assumptions only existed notionally. Thus, the purpose of the hypothetical assumptions of the fiction was 'self-evident' and did not question the 'real' residence of the CFC. This effect meant that the income based on the CFC was notionally defined and was not the same as that of the CFC.

In *Fowler*, the fiction was that employment was regarded as trade for the United Kingdom tax calculation. The income from employment became income from trade. In this regard, the court of appeal found that the approach to deeming was not in doubt; the fiction was generally given the ordinary meaning in the context it was written.[165] Henderson LJ states:

> 'The statute says that one must imagine a certain state of affairs. It does not say that, having done so, one must cause or permit one's imagination to boggle, when it comes to the inevitable corollaries of that state of affairs…
>
> What, then, is the state of affairs which [the fiction] requires us to imagine…It is that the relevant duties of Mr Fowler's actual employment are instead to be treated for income tax purposes as the carrying on of a trade in the UK.
>
> Accordingly, in the imaginary world which we have to enter, the actual earnings of Mr Fowler from his employment must instead be regarded as profits (or, more accurately, as receipts which form part of a computation of trading income) of the trade which he is now deemed to have carried on.'[166]
>
> 'Furthermore, to the extent that Mr Fowler's activities were comprised in the deemed trade, they could not simultaneously be regarded for any income tax purposes as performance by him of the duties of his actual employment.'[167]

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[163] *Bricom* supra note 7 at 375-6.
[164] Ibid.
[165] *Fowler* supra note 16 para 20.
[166] Ibid para 38.
[167] Ibid para 39.

Henderson LJ., gave full effect to the fiction, stating that the effect was that the two assumptions could not exist simultaneously. The fiction, therefore, replaced the actual facts and the product of the fictional income was maintained.

Both cases, therefore, approached the fiction in the same way in that it was not a special rule for domestic tax purposes, but the results were the complete opposite. To better understand the divergence, the below assessment begins with the theoretical effect of the *'as if'* fiction.

3.3. The effect of the theory of the *'as if'* on the character of *'income'*

The view that fiction in tax law is not a special rule can best be explained in the formation of tax law. Tax law was established based on 'income' as an artificial conception because tax law never created the 'income' it taxed.[168] Rather, 'income' was essentially an economic concept.[169] Tax law, therefore, represented the legal construct of the economic exchange as the fiction of the fact itself.

The effect of fiction in tax law is, in this view, no different to any other tax provision when the taxing system as a whole can be seen as a fiction.[170] Thus, on this basis, fiction does not necessarily have any special effect or meaning other than what is described by the fiction. The cases of *Bricom* and *Fowler*, however, derived a difference of view to effect of the same *'as if'* terminology.

In so far as the effect of the *'as if'* fiction is concerned, Chapter One introduced an example in legal theories referring to *The Philosophy of the As-If* by *Vaihinger.*[171] The premise follows a simple logic:

> 'In a fiction we treat X *as if* it were Y to better understand [X], we very well know that X actually is not Y or cannot be Y.'[172]

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[168] John Prebble, *Fictions of Income Tax* (Victoria University of Wellington, paper no. 29/2011 2011) at 3-4. Available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1604978, last accessed on 30 July 2019; Afton Titus, *Pienaar Bros (Pty) Ltd v CSARS, Retroactive fiscal legislation and the rule of law: has South Africa just taken a step back in its Constitutional Democracy?* (2019) 136(3) *SALJ* 404 at 409.
[169] Williams op cit note 158 at 213.
[170] Geoffrey Samuel 'Is Law A Fiction' in M. Del Mar & W. Twinnings (eds) op cit note 1 at 31. The view in tax law, see John Avery Jones 'Fictions' in *X v State Secretary for Finance (Fictitious Wage 3)* 2016 (20) ITLR 125 (Hoog Raad (Dutch Supreme Court)) at 141.
[171] Kletzer op cit note 1, at 23-4.
[172] Ibid.

The legislative effect of *'as of'*, because it is set in contradiction to actuality, creates the normative reality for something it is not.[173] Without this contradiction, the *'as if'* fiction would have no purpose. The effect is noted by Kelsen:

> 'When A is to be treated as if it were B, then by that he is not asking to treat A and B in order to better know A, even though we know A not to be B. Rather the legislative act normatively *makes* A a B. This means that the same normative consequences which are attached to B are by means of this "fiction" also attached to A. The legislator does not ask us to treat A "as if" it was a B, but asks us to treat A "just as" B.'[174]

From the above statement, A is 'just as' B. The theory, therefore, determines that the *'as if'* attaches the same normative consequences of B to A. To be effective, the *'as if'* fiction relies on the importance of the subject matter of the wording of the provision accompanying the context in which the fiction is to be set. That is, the reference to *'as if'* is not self-executing in the sense that without B the '*as if'* has no meaning.

Vaihinger develops four general characteristics as to why an '*as if'* fiction is effective. These are:

i. Fictions are a contradiction with reality;
ii. Fictions are fundamentally provisional;
iii. The fiction has to be expressly stated, and
iv. The fiction has to be expedient.[175]

Collectively, these traits provide the normative effect of an *'as if'* by treating A 'just as' B. Points (i) and (ii) confirm that the *'as if'* subject matter assumes a counter-factual identity given by the *'as if'*. In the above example, A is not B, but the *'as if'* 'makes' A a B. This treatment is exclusive, specific and provisional, meaning that the fiction is assumed only for the purposes of A. On this point, however, it means that the fact of A and the fiction of A will necessarily coexist – the question is, which prevails for statutory construction? Points (iii) and (iv) answer that question.

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[173] Ibid.
[174] Ibid.
[175] Ibid.

Points (iii) and (iv) confirm that the *'as if'* must expressly detail what the desired effect must be, in order to transfer the identity of one to the other. The instructed identity then substitutes the fact for fiction, that is to say, the factual identity of A is substituted with that of B. Since the *'as if'* assumes a transfer of identity, any limitations within that transfer must also be expressly defined.

The direct theoretical effect of *'as if'* is that 'when A is…treated as if it were B…the legislative act normatively makes A a B'.[176] The result of the *'as if'* theory is simply that, in one form or another, A is just as B, A is B, A is made a B, or A becomes a B.

The theory suggests a full transfer and substitution of one subject matter based on another. In this way, the effect is similar to deeming rules in that it directly subjects to tax the consequences of B that attach to A but from the view of A. Stated in another way, it is the same as A having been taxed directly on B's income or activity. The question of 'actual' and 'fictional' income in this regard, become one and the same.

The *'as if'* theory can be seen in any number of derivations of the above principle, both directly and indirectly for the taxpayer. The below examples are illustrations of this theory *[note, the below hypotheticals contrast with the current effect and drafting of section 9D discussed in Chapter 2.2 to 2.3].*

Assume the taxpayer is X, and because the assumption of *'as if'* is a full transfer and substitution of the identity of one subject matter for another, there are a number of effects for taxpayer X, as below

i. If taxpayer X has actual income A, that is taxed *'as if'* it was income B, income A becomes B, and income A ceases to exist. This means that the income B is what is taxed for taxpayer X – logic in *Fowler case*
ii. If taxpayer X has actual income arising from actual activity A, and actual activity A is taxed *'as if'* it were fictional activity B, activity A becomes activity B, and activity A ceases to exist. This means that the actual income is regarded as the fictional activity from B, which is what is now taxed for taxpayer X – logic in *Fowler case*

[176] Ibid.

iii. If taxpayer X has no actual income but is taxed *'as if'* it were taxpayer Y who has actual income, this means that the actual income of taxpayer Y is what is taxed for taxpayer X – *taxpayer's submission in Bricom*[177]

iv. If taxpayer X is treated *'as if'* it were taxpayer Y who has activity B, for taxpayer X, it is the same as saying the income from activity B is what is taxed for taxpayer X – *taxpayer's submission in Bricom regarding the effect of the fiction of dual residence/by deduction from Fowler case in (ii).*

What arises from the above scenarios in examples *i* and *ii,* is that the taxpayer has income that changes in identity because of an *'as if'* fiction. The *Fowler* case provides an example of this, which accords to the above theory. The case found that A's actual identity could not co-exist with the fictional identity given to A by B, and the fictional identity of A being 'just as' B, therefore, prevailed.[178]

In the case of secondary taxpayers, that is, examples *iii* and *iv* above, when one taxpayer, X, is taxed based on the activity or income of another taxpayer, Y, the *'as if'* fiction makes no distinction between X and Y as separate persons, and what results can be seen to be a direct attribution of that income or activity to taxpayer X. In the *Bricom* case, Millett L. appeared to endorse the above view, in the case of statutory deeming and the income held by deemed to be taxed for third parties, resolving:

> 'Exempt income does not change its character or lose its exemption merely because it is deemed to be the income of another person or is imputed to him….[A] Double Taxation Agreement can enure for the benefit of a third party…if the [domestic tax] rules deemed the income [of one taxpayer] to be the income of the taxpayer'[179]

This theme emerged from the taxpayer's argument by referring to the case of *Hughes v Bank of New Zealand*.[180] The case indicated that interest from exempt securities did not cease to be as such by being included as a component element of a taxpayer's calculated profits. If a taxpayer's profits included any component element from another taxpayer, it was also the same nature of that element for that taxpayer.

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[177] *Bricom* supra note 7 at 378.
[178] See footnote 167.
[179] *Bricom* supra note 7 at 377-8.
[180] *Hughes v Bank of New Zealand* 1938 AC 366 (UKHL) appearing in ibid at 378-9.

Thus, unlike the *Bricom* decision, however, there does not appear to be a limitation to the effect of *'as if'* from the above theory. The taxpayer's submission in the *Bricom* case, therefore, presented a strong argument that the fictional language had the same full effect and was not notional – meaning, in CFC rules, that it was not merely a 'sum equal to the apportioned part of the chargeable profits but the apportioned part of the chargeable profits itself'.[181] The *Fowler* case in fact confirmed *Vaihinger's* theory, by giving full effect to the *'as if'* language by treating employment as trade.

The view that fiction can be given a full effect is discussed next.

3.4. A taxable fiction is provided an ordinary meaning unless it is qualified

The above theory of *'as if'* indicates that the *'as if'* fiction can be given a full effect, that is, the ordinary meaning attributed to an *'as if'* fiction is based on X assuming Y's character of income or activity. Contrary to the *Bricom* view, the below authorities indicate that fiction in tax law can assume the full effect of an ordinary 'fictional' meaning provided by the plain statutory language, that is, the fiction is not a notional definition.

In the House of Lords in *East End Dwellings Co. Ltd. v Finsbury Borough Council* for example, Lord Morton of Henryson details the difficulty of fictional terminology which is not guided by the statutory wording of the provision.[182] The case had to determine the effect of the phrase:

> '…the value which it would have if the whole of the damage had been made good before the date of the notice to treat.'[183]

The statutory consideration regarded the consequences of a rebuilt building that was completely destroyed in war. The question was whether or not that building could still be subject to rent restrictions on the fiction that it had been repaired rather than rebuilt. If the building retained its former identity after it had been reconstructed, the former restrictions on rents would, therefore, continue to apply.

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[181] Ibid at 375.
[182] *East End Dwellings Co. Ltd. v Finsbury Borough Council* 1951 (2) ALL ER 587 (UKHL) at 593.
[183] Ibid.

Morton L. resolved that the majority in the court of appeal involved reading the words as:

> '…if the whole of the damage had been made good before the date of the notice to treat' as if they had been 'if the damage had never occurred'.[184]

If it were read as if the damage had never occurred, it would mean that the fiction surrounding making good the property was unaffected by the notice to treat, which was what was required by the statutory wording of the provision. Morton L. found that the view of not giving effect to the words in question could not be justified when its departure was so far from the wording of the legislation that there was no context which allowed it.[185]

Lord Aquith of Bishopstone agreed, finding –

> '…nothing would have been easier than to provide that the value should be assessed as if no war damage had occurred'.[186]

Aquith L. resolved that the meaning of the words was plain enough, and even if the 'policy' of the legislation could legitimately be invoked as an interpretative factor, it should not be used only to produce the desired result.[187]

This logic can be compared to the decision in the *Bricom* case. In *Bricom*, Millett L. found that the statutory assumptions on which the fiction was based was ambiguous.[188] Millett L. proceeded to read the fictional assumptions with the effect that it had the no 'real' meaning. Thus, if the counter argument runs on the logic of Lord Aquith's view, that is to say, if it was to be fully 'notional', nothing would have been easier than to state 'notional' in the legislation.[189] The draft CFC proposals did include that language, however, it did not match the CFC legislation ultimately adopted.[190] The logic adopted in the *Bricom* decision did not, therefore, give full effect to any of the statutory assumptions even when no limitations were provided by the statutory wording.

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[184] Ibid.
[185] Ibid.
[186] Ibid at 599.
[187] Ibid.
[188] *Bricom* supra note 7 at 375-6.
[189] Discussed in Chapter 2.3.2.
[190] Ibid.

In *Fowler*, Lord Justice Henderson in the majority judgement in the court of appeal, found that an *'as if'* was a deeming rule, referring to the often-cited wording of decision of *Lord Asquith* as above.[191] Lord Asquith found that when something is to be treated as real, it must also be imagined as real the consequences of treating it as such. Lord Asquith resolves:

> '[When] the statute says that you must imagine a certain state of affairs; it does not say that having done so, you must cause or permit your imagination to boggle when it comes to the inevitable corollaries of that state of affairs.'[192]

This reasoning confirmed that the meaning provided by the statutory fiction was the ordinary meaning assumed for the purposes of the provision. A similar view referring to this dictum arose in the *Marshall (HM Inspector of Taxes) v Kerr*, a United Kingdom tax case dealing with capital gains.[193] There, the court of appeal was unanimous in finding that the fiction was given an ordinary meaning.[194]

Gibson J. states, in the leading judgement from the court of appeal, that a limitation could not be read into a tax provision unless the provision expressly stated it, finding that the purpose of a fiction may not always be clear, but the purpose must not be 'self-fulfilling'.[195] In the House of Lords, the Gibson J. methodology was approved.[196] A good example that consolidates the above views is made from the below summary (in the author's own words) to the approach to fiction derived in that case:

> 'I start with the issue of the approach to the construction of deeming provisions. *IRC v Metrolands (Property) Ltd* states that when considering the extent to which deeming provisions should apply, the court is entitled and bound to ascertain for what purpose and between what persons the statutory fiction is resorted to.[197] If the fictional meaning would lead to an absurd result, unless its application is clearly be within the purpose of the fiction, it should be applied. It may not always be clear what the purpose of deeming is and if construction commences with a purposive approach there is a real danger that the purpose is a self-fulfilling assumption.
>
> I do not read *Metrolands* as laying down new law, requiring in the case of deeming, as the abandonment of the golden rule of statutory construction.[198] That is to say construing the

[191] *Fowler* supra note 16 at 37.
[192] *East End Dwellings* supra note 182 at 599.
[193] *Marshall (HM Inspector of Taxes) v Kerr* 1993 STC 360 at 365. In that case, the court had to determine if a settlor who submitted an instrument to settle a deceased's assets was deemed to be disposed of by the deceased or settlor.
[194] Ibid.
[195] Ibid at 366.
[196] *Marshall v Kerr* 1995 (1) AC 148 (UKHL) at para. 20.
[197] *IRC v Metrolands (Property) Ltd* 1981 STC 193 at 208.
[198] *Marshall* supra note 193.

> grammatical and ordinary sense of the words to be adhered to. If the meaning of those words were cryptic or equivocal, it would no doubt be permissible to interpret them in light of a number of extrinsic considerations. Of course, if the policy of the Act and the purposes of the fiction can be derived from the wording of the Act, it is permissible to try to give meaning to that policy in a purposive approach.[199]
>
> For my part, I take the correct approach in construing deeming provisions to be to give the words used their ordinary and natural meaning unless prohibited from doing so. I further bear in mind that because one must treat as real that which is deemed to be so, one must treat as real the consequences and incidents inevitably flowing from or accompanying that deemed state of affairs. In particular, I have been unable to ascertain from the statutory language the limited purpose given by the statutory language. The fiction is not qualified in any way.[200]
>
> I see no proper basis for distinguishing computational purposes from other tax purposes in the absence of express words. I see no justification for deeming to apply for limited purposes. Plainly it applies.'[201]

There does not, therefore, appear to be a general rule that a fiction is necessarily limited to a notional meaning as it were in the *Bricom* case.

In the South African Supreme Court of Appeal, the case of *Tradehold* resolved that domestic fictions were not limited in meaning.[202] The court reflected on the case of *R v Norfolk County Council*, where Cave J. stated:

> 'Generally speaking when you talk of a thing being deemed to be something, you do not mean to say that it is that which it is deemed to be. It is rather an admission that it is not what it is deemed to be and that, notwithstanding, it is not that particular thing, nevertheless it is deemed to be that thing.' [203]

In addition, the court was referred to the case of *New Union Goldfields Limited v Commissioner for Inland Revenue* where van den Heever remarked:

> '…once the Legislature "deems", it departs from reality.'[204]

The court resolved that no limitation could be read from these cases as to why the fiction had a limited meaning, finding that it would be *'absurd'* if a fiction were not given effect like any other rule.[205]

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[199] Ibid at 366.
[200] Ibid.
[201] Ibid at 367.
[202] *Tradehold* supra note 153 para 12.
[203] *R v Norfolk County Council* 1891 (60) LJ QB 379 at 380 in ibid.
[204] *New Union Goldfields Limited v Commissioner for Inland Revenue* 1950 (3) SA 392 (A) at 407A.
[205] *Tradehold* supra note 153 para 10.

Importantly, the latter of the above summary of Gibson J. states that there was no proper basis for distinguishing computational purposes from other tax purposes in the absence of express words. Meaning, the tax calculated on a fiction based on an amount and the actual income itself are not necessarily distinct concepts.

In 2015, the United Kingdom Supreme Court ruled on an important development in this regard; the case surrounded the effect of calculating an amount 'computed by reference to' another as simply a plain term that means the income was 'the same'.[206] Thus, it is submitted that a calculation 'equal to' the CFC amount read with the *'as if'* assumption is simply another means of taxing the same 'income' of a CFC. A tax charging provision would not, therefore, change the character of the underlying CFC's income.[207]

Thus, the difference in construction between the *Fowler* and *Bricom* cases is clear. The court in *Bricom,* found a limited basis of construction in that the use of '*as if'* meant that anything that flowed from the '*as if*' terminology was a *notional* definition. The fact that it is not the reality, however, supported the very purpose of the fiction and does not mean it has no real effect. The logic to the above cases, however, indicates that the effect of the fiction is given an ordinary meaning and full effect, unless it appears to be limited or qualified by the language itself.

In addition, the theory to the *'as if'* suggests a full transfer of identity from one subject matter to another, which is not limited to a notional meaning. This theory can be validated by case law on the matter of deeming and by giving full effect to the statutory fiction. The *Fowler* case finds the same logic and appears to affirm the view that the fiction could be given its ordinary meaning.

Collating the above effect to that of the *'as if'* fiction as viewed by *Vaihinger*, and the effect of *'as if'* derived in *Fowler*, it is submitted that the *'as if'* has no limited meaning and, given a full

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[206] *Anson* supra note 29 para 114.
[207] David Goy, *Double Tax Treaties and Section 739 and 740 ICTA1988*, at 3, online article, available: http://taxbar.com/wp-content/uploads/2016/01/Double_Tax_Treaties_DGY_000.pdf. Last accessed 30 June 2019.

effect, may be provided with the ordinary meaning. A calculation based on an amount also represents 'the same' income.

3.5. Applying the theory of the *'as if'* fiction to South African CFC rules

It is useful to revisit the definition of *net income* in South African CFC rules with the above view in mind. The definition of *'net income'* in CFC rules was the tax charging provision and states:

> '…an amount equal to the taxable income of that company determined in accordance with the provisions of this Act as if that controlled foreign company had been a taxpayer, and as if that company had been a resident for purposes of the definition of 'gross income''[208]

Returning to the bonds example used by National Treasury[209] read with the full effect of the *'as if'* as above, assume taxpayer Y is the CFC with interest income; taxpayer X is the South African tax resident shareholder of taxpayer Y.[210]

The consequence of the above theory of *'as if'* and the above definition means that the amount of X's taxable income is *'as if'* it was Y. That effect is that X is taxed *'just as'* Y. The question as to whether or not X is taxed on Y's actual interest is self-evident and the direct consequence of taxing X as Y. This is irrespective of whether or not X has the actual interest of Y, since X has a fiction of Y's interest, the purpose of which is to directly attribute the tax to X.

Whether Y 'pays' interest to X fictionally and X is taxed on the fictional 'receipt' indirectly, or X is seen to be the holder of Y's bonds fictionally and is taxed on the interest of Y directly, the tax consequences are one and the same. Thus, the question as to whether or not X is taxed on the same income as Y is the logical corollary of the fiction. In addition, the question as to whether X is seen to be taxed on the interest owned in Y is therefore, the logical corollary of the fiction.

The same methodology can be extended to income from trade. If Y had a trade, the 'income' for X, because X is taxed 'as if' X was Y, means that X is taxed on an amount of profits from

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[208] Section 9D(2A), Act 58, 1962.
[209] See Chapter 2.3 of this minor dissertation.
[210] Ibid.

Y's trade. Thus, if a CFC has sales income, the resident shareholder is taxed on an amount of sales income.

In certain cases, a taxpayer may be taxed on an amount based on one taxpayer, that deems that amount to be derived for the other taxpayer, akin to fiscally transparent entities.[211] This means that for the taxpayer, a tax on sales income means that the sales were also deemed to be generated. In that case, the view is that X may carry on X's own fictional trade because of the control of Y's profits. The result is simply the view that the same income generated by the entity (the CFC) is taxed directly for the shareholder who controls it.[212]

This also begs the question, if X and Y are separate taxpayers, and Y carries on a trade when X is taxed on taxable income 'as if' X was Y, the question is if there is a deemed trade that transfers to X or if it is just the deemed profits from Y that X is taxed on? This view is discussed in Chapter 4.[213] It may be possible in those cases to argue that X has a deemed business as a result of controlling the income on Y's business.

In the approach of the Special Commissioners in the English case of *IRC v Willoughby* however, there was no transfer of character or activity -

> 'In my opinion there is a distinction between actual income of an individual and actual income of another person which is deemed to be the income of the individual. Such income is not industrial or commercial profits of the individual nor quoad the individual is it deemed to be industrial or commercial profits or deemed to be his income as if it were such profits.'[214]

Although this case was eventually rejected in the House of Lords,[215] it does not accord with what was endorsed in the court of appeal in *Bricom,* in that deeming rules did not change the fictional identity of the income even when deemed to be that of another person.[216]

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[211] See a similar comment in JF Avery Jones 'Partnerships and double taxation agreements' (1987) 2 *British Tax Review* 88 at 91-92. Referring to *Padmore v Inland Revenue Commissioners* 1987 S.T.C. 36; 1987 (1) WLUK 763 (Ch D). In South Africa, the case of trusts, see *Secretary for Inland Revenue v Rosen* 1971 32 SATC 249 regarding the 'conduit-pipe principle', following the logic – if taxpayer X owns the income of taxpayer Y, taxpayer X may be seen to generate the income of taxpayer Y when the income is taxed for taxpayer X.

[212] Section 9D(1) defines control of any foreign company as more than 50 per cent of the total participation rights in that foreign company. The view is that the income is always controlled, but not the CFC effectively managed.

[213] Discussed in Chapter 4.4.

[214] *IRC v Willoughby* 1995 STC 143 at 169.

[215] *IRC v Willoughby* 1997 STC 995 (UKHL).

[216] See footnote 179.

In addition, on the *Fowler* decision, there has been some resistance that an *'as if'* fiction could be a deeming rule. Certain United Kingdom commentators note:

> '…I would respectfully doubt that as if creates a trade as a matter of domestic law…The Explanatory Note to s 12 [of the ITTOIA – the Fowler case dealt with s 15] which treats mines, quarries etc as if the concern were a trade says:
>
> Th[at] section does not deem the concern to be carrying on a trade. That section requires the taxpayer to be carrying on a trade as defined as defined in section 158(2) of TCGA…
>
> I suggest that the same would follow as a matter of treaty interpretation which is sensitive to nuances in the drafting of domestic law.'[217]

The above view indicates that the *'as if'* fiction does not have a full effect and deem the concern to be carrying on a trade. The court of appeal in the *Fowler* decision, however, appeared to accept the logic that *'as if'* constituted a deemed trade for Mr Fowler, and therefore, the carrying on of a fictional trade.[218] In addition, there does not appear to be a limitation that the fictional income cannot assume the ordinary meaning of that fiction, both from case law generally, and *Vaihinger's* theory.

The case of *Fowler,* therefore, confirms what the *Bricom* case did not – that is, that the fiction of *'as if'* is not unlike deeming rules which can be given an ordinary meaning. Unlike the *Bricom* decision, however, case law has generally been susceptible to giving full effect to the ordinary meaning of fiction.

3.6. Summary of findings and preliminary conclusions

This chapter argued that the *'as if'* fiction had an effect similar to a deeming rule. This view was reconciled from *Vaihinger's 'as if'* theory, which determined that the effect of the *'as if'* supported a full transfer of identity and substitution of one subject matter for another. Thus, if taxpayer X was taxed *'as if'* it was taxpayer Y, the effect for taxpayer X was that it was seen to be 'just as' taxpayer Y. The result of the fiction was that the income of taxpayer Y became taxable for taxpayer X.

[217] Avery Jones op cite note 17 at 392-3.
[218] *Fowler* supra note 16 para 41-43.

In this way, the question of whether or not the amount of tax calculated for taxpayer X represented the same income as that of Y was the logical corollary arising from the fiction that X was taxed *'as if* it was Y. In this view, the fictional 'income' was not a purely notional definition when the effect was that the income of Y simply became that of X.

A number of tax cases referred to in this chapter supported the view that generally, fiction in tax law can provide the fictional *'income'* with the ordinary meaning of that fiction. The theoretical result of *'as if'* and the ordinary meaning associated with deeming rules are, therefore, similar conceptually since both aim to attribute a tax by way of fiction to the taxpayer.

The above findings accord with the position that an *'as if'* fiction can be provided the ordinary meaning of the fiction. That same view was the finding in the *Fowler* decision, which gave full effect to the *'as if'* fiction as a deeming rule. Applying this view, therefore, confirms an important aspect about statutory fictions using the *'as if'* terminology in South Africa CFC rules. The first is that South African CFC rules using the *'as if'* terminology may support the full ordinary meaning of that fiction. Thus, a tax calculation based on another taxpayer simply means that the income or activity is taxed for that South African resident, being in a CFC rule, the resident shareholder. The result would not, therefore, appear to separate the 'income' and an amount taxed 'based on income' as it was in the *Bricom* case.

By consolidating the above views in line with the *Fowler* decision and the basis of the theory of *'as if'* by *Vaihinger*, this chapter concludes that, for the South African shareholder subject to CFC rules, the *'as if'* results in the taxation on the deemed amount, being defined as the 'net income' of a CFC. The result is taxation on one resident taxpayer – the CFC, and taxation on that same income attributed to another taxpayer, the shareholder – a resident/resident-based form of double taxation therefore arises. The next question, which is answered in Chapter Four, follows the view that resident/resident based attributions can be accommodated in tax treaties for the South African resident shareholder.

CHAPTER FOUR – THE RECONCILIATION OF SOUTH AFRICAN CFC RULES TO THE RULES OF TAX TREATIES

4.1. Introduction

The objective of this chapter is to reconcile the findings from the previous chapters into a hypothetical fact pattern concerning South African CFC rules and the rules of South Africa's tax treaties. Based on the logic found in Chapter Three, a fiction can be given an ordinary meaning. If, therefore, the *'as if'* can be seen to be a deeming rule, the amount determined in CFC rules may be the same income of the CFC and in the same character of CFC income for the shareholder. This chapter continues on this basis. The case study refers to Article 7(1) as used in the OECD model tax convention and South African tax treaties. This chapter concludes on any potential conflicts of CFC rules and tax treaties following this view.

Thus, reading the definition of *net income* with the terms *'as if'* simply means that the shareholder is taxed on an amount just as the CFC and just as the CFC was a tax resident taxpayer. That is, the shareholder is taxed on an amount of the same income of the CFC deemed to be that of the shareholder. It also means that the CFC's income is taxed on a worldwide basis in South Africa.[219] The most important question, therefore, surrounds how the same income of the CFC can be taxed consistently with tax treaties in South Africa.

The definition of *foreign company* used in section 9D is defined as a company which has its effective management outside of South Africa.[220] The same test generally establishes the tax residency of corporations for tax treaty purposes.[221] Commentators note that CFC rules can, therefore, only apply to a shareholder if the foreign corporation is not a tax resident and remains a CFC after the effective management test for the purposes of tax treaties.[222] In addition, the definition of *control* used in section 9D is directed at control of income and not control of management.[223] The question is, therefore, not the determination of the tax residence of the

[219] For this effect, but not in this same context, see Tickle op cit note 21 at 675.
[220] Section 9D(1) of the Income Tax Act, 58, 1962
[221] Article 4(3), OECD, *Model Tax Convention on Income and on Capital* (2017).
[222] K. P. Singh, 'An international comparative study of South African controlled foreign company legislation', PhD thesis Unisa 2014) at 150.
[223] Section 9D(1) of the Income Tax Act, 58, 1962. See an alternative in Tracy Gutuza 'Has Recent United Kingdom Case Law Affected the Interplay between Place of Effective Management and Controlled Foreign Companies' (2012) 24 *South African Mercantile Law Journal* 424 para. 6-7 at 435-6.

CFC for tax treaty purposes, but rather, how the income taxed for the shareholder based on the CFC can be reconciled to the rules of tax treaties.

The solution, it is submitted, returns to the effect of a CFC rule when the amount determined by a CFC rule is the same CFC's income attributed to the shareholder. This was the finding of the effect of the *'as if'* as a deeming rule in Chapter Three. From Chapter One, a resident/resident-based attribution thus occurs – a similar issue was founded in the cases of *Anson* and *Smallwood* respectively.[224]

Those cases resolved that tax treaty relief may be afforded to taxpayers when the tax in one state was computed with reference to the same income in the hands of two different taxpayers, and, when the one taxpayer's income was used to determine the tax liability of the other. This effect is similar to the tax computed in CFC rules as above. The principle was that tax treaties could accommodate tax treaty relief for both 'economic' and 'juridical' double taxation.[225] This Chapter indicates that Article 7(1) provides a strong indicator that this distinction becomes difficult to ascertain if one looks at the term *enterprise* in relation to CFC rules.[226]

Chapter Three also determined two important findings akin to the above, firstly, that an *'as if'* fiction may be seen as a deeming rule, and secondly, a deeming rule can provide the ordinary meaning of that income or activity to third party. Thus, tax treaties may also enure for the benefit of a third party, in the cases of so-called double economic taxation.

The next section, therefore, provides a hypothetical scenario surrounding the effect of statutory deeming when the *'as if'* is provided the ordinary meaning of the fictional income taxed by a CFC rule. The argument begins with a recent example of CFC rules appearing in the SCA in *Sasol Oil v C.SARS*.[227]

4.2. The case study fact pattern

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[224] Discussed in Chapter 1.2.
[225] Ibid.
[226] See note 238 below.
[227] *Sasol* supra note 44.

In 2018, the SCA ruled on its first CFC case in the context of simulated transactions. A simple example of potential double taxation may have arisen in the case of *Sasol Oil v C.SARS* on sales of crude oil connected to a CFC resident in the Isle of Man.[228] The CFC was resident in the Isle of Man and taxed in that state at a lower rate of tax than South Africa. The case did not deal at any length with the discussion of CFC rules and tax treaties, since no treaty existed with the Isle of Man. The case is noteworthy, however, for what was said surrounding the basis of the tax assessment using section 9D.

The South African Revenue Service sought to tax the sales of crude oil between the CFC and its connected parties using 9D to do so. Section 9D(9A)(a)(i)(aa) was a specific provision which disallowed the exemption from sales included in a foreign business establishment derived from resident connected persons of the CFC. The CFC would otherwise have been attributed an amount equating CFC *'net income'* and the resident shareholder company in South Africa assessed on an amount equal to the sales less allowable expenses. The submission by the Commissioner was that the structure of the CFC avoided residence-based taxation in South Africa.[229] Recall from Chapter Two and Three, that the effect of *'as if'* when regarded as a deeming rule would determine this amount as the same as the sales income itself.

The question follows this logic and posits the hypothetical position as to whether or not the sales amount may have been precluded from taxation in accordance with South Africa's tax treaty obligations, had the CFC been disallowed the foreign business exemption and taxed in South Africa and, had there been a tax treaty with the Isle of Man?

4.3. The interaction of section 9D and Article 7(1)

The rules of section 9D

From the above pattern, the CFC has actual sales income. For section 9D, if the *'as if'* is given the full effect, for the resident shareholder it may arise that the ordinary meaning of *net income* may represent a deemed amount of the same CFC's sales income.

[228] Ibid para 31-34.
[229] Ibid para. 35.

The more complex question which arose in Chapter Three in the case of deemed profits was who was deemed to carry on the business associated with those profits?[230] There were two potential views. Either the shareholder is taxed on the amount of CFC sales income and the CFC carries on the business, or, the shareholder is seen to carry on their own fictional business because of the profits attributed to the resident shareholder directly were controlled. As will be discussed below, Commentators and courts share mixed views surrounding this fictional effect in tax treaties.[231]

<u>The rules of Article 7(1)</u>

Article 7(1) of South Africa's OECD model-based tax treaties follows the well-founded principles attributing income on business profits.[232] It states:

> The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment…may be taxed in that other State.[233]

Article 7(1) provides both a basis of taxation in the form of article 5 dealing with permanent establishments, and avoidance of double taxation provided by the wording *'shall be taxable only',* which mandates exclusive taxation in the state of the enterprise. This is because Article 5, which includes the definition of the concept of permanent establishment, may be relevant in the determination of whether or not a CFC rule views the CFC as an enterprise that may be taxed in South Africa. The definition of permanent establishment in section 1 of the South African Income Tax Act establishes the same basis of taxation with reference to a permanent establishment, this states:

> '[A] permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development …'

[230] See footnote 213, which generally followed the question of how an amount of tax could arise without taxable income, or without the income generating activity.
[231] See discussion in header 4.4 below.
[232] See OECD, *Model Tax Convention on Income and on Capital: Commentary* on Article 7 para 3 (2017) first appearing in 1977.
[233] Article 7(1) OECD, *Model Tax Convention on Income and on Capital* (2017).

The term 'profits', the OECD has held, has not been a necessary definition in the model tax convention.[234] This is because the term is an understood term to mean all income from the carrying on of an enterprise. The terms 'enterprise' and 'enterprise of a Contracting State' therefore appear in article 7(1) of the model tax convention. Article 3(1) defines the term enterprise as the *carrying on of any business*, and enterprise of a contracting state as the *carrying on of any business by a resident of a contracting state*.[235]

Thus, the importance of who carries on a business for the purposes of tax treaties therefore emerges.[236] Commentators have found that for this reason there exists a long history to whether or not the effect of domestic CFC rules conflicted with tax treaties based on the OECD model tax convention, particularly Article 7(1).[237] Lang highlights the potential issue:

> 'The legal consequences provided by the distributive rules [of tax treaties] apply to the persons who are resident in accordance with the tax treaty to the extent that income was attributed to them pursuant to domestic law. There has been some debate whether this is different for Art. 7(1) since Art. 7(1) refers to "profits of an enterprise of a Contracting State" and seems to imply that, for purposes of attributing corporate profits, Art. 7 does not make a distinction based on the taxpayer to whom the income was attributed pursuant to domestic law.'[238]

The above argument appears to introduce the theme that article 7(1) may relieve double economic taxation arising from CFC rules without difficulty. This is because article 7(1) may apply to the term *profits of an enterprise of a contracting state* without drawing a distinction as to the taxpayer taxed on the profits.

For the shareholder as the resident taxpayer, *enterprise* in article 3(1)(c) of the model tax convention means the carrying on of any business,[239] and article 3(1)(d) states that the enterprise of a contracting state means the enterprise carried on by a resident,[240] it appears that the shareholder must carry on the enterprise of the CFC and not only have an amount of profits of the CFC enterprise to be taxed therein. In that view, article 7(1) may apply to protect different taxpayers based on the income from the same enterprise, because the basis of

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[234] OECD, *Model Tax Convention on Income and on Capital: Commentary* (2017) to Article 7 para 71 (2017).
[235] Article 3(1) (c)-(d) OECD, *Model Tax Convention on Income and on Capital* (2017).
[236] De Broe op cit note 43 at 59 header 6.3.2; Daniele Canè 'Controlled Foreign Corporations as Fiscally Transparent Entities - The Application of CFC Rules in Tax Treaties' (2017) 9 *World Tax Journal 521* at 539.
[237] Canè ibid at 525-6. J. Aigner, U. Scheuerle and M. Stefaner 'General Report' in Lang (ed) et al op cit note 114 at 32-34; Lang op cit note 160 at 54; Rust op cit note 47 at 495.
[238] Lang op cit note 160 at 55.
[239] Article 3(1)(c), OECD, *Model Tax Convention on Income and on Capital* (2017).
[240] Article 3(1)(d), ibid.

taxability set by tax treaties is that the profits of an enterprise must be an enterprise carried on by the resident, rather than merely profits attributed to that resident.

It is submitted, that the most important question arising from a CFC fiction is, therefore, who is seen to carry on the enterprise on the amount of CFC imputed business profits (sales)?

4.4. Who has an enterprise for the purposes of a CFC rule?

In tax treaties, there are three possibilities for the shareholder who calculates their tax liability based on a CFC rule:

a) Is the resident shareholder the enterprise (and the CFC fiscally transparent)?
b) Is the CFC the enterprise, and is there a potential conflict with article 7(1) and the basis of taxation set by the definition of permanent establishment?
c) Is there an alternative remedy (tax saving clause)?

a) Is the resident shareholder the enterprise (and the CFC fiscally transparent)?

The view that the shareholder is deemed to be the enterprise aligns with the concept that CFC rules had a similar pattern of operation to partly fiscally transparent entities, and is not a new idea in tax treaties.[241] That foundation stems from the pattern of taxing an amount of the CFC at the level of the shareholder irrespective of the CFC's tax residence.[242] Thus, the logic can accord with South African CFC rules because the premise is that CFC rules can only apply when the CFC is a tax resident for tax treaty purposes outside of South Africa.[243]

The feature of fiscal transparency considers the share of the transparent entity's income, depending on that nature, to be derived by the resident recipient or to be the profits of an enterprise carried on by that resident.[244] That conception was traditionally applied to beneficiaries of trusts or partners in partnerships, although the OECD definition holds whether

[241] Rust op cit note 47 at 495 referring to OECD, *The application of the OECD Model Tax Convention to Partnerships* (1999), example 16 ; Lang op cit note 160 at 53-54.
[242] Canè, *Controlled Foreign Corporations as Fiscally Transparent Entities - The Application of CFC Rules in Tax Treaties* at 539 fn 57 of that article.
[243] See footnote 222.
[244] OECD, *Model Tax Convention on Income and on Capital: Commentary,* Commentary on Article 1(2) para 9 (2017).

that entity has a legal personality and is itself a tax resident person (partly fiscally transparent) or not (wholly fiscally transparent).[245]

The definition of fiscal transparency was added to the commentary to the 2017 model tax convention to clarify situations where the domestic tax law of one contracting state taxes the income (or part thereof) of an entity not at the level of the entity, but at the level of persons who have an interest in the entity.[246] It was also included as a provision to the 2017 model tax convention that stated the same.[247]

Article 1(2) states:

> 'For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.'[248]

Thus, when article 7(1) applies to the tax on an amount of income of a CFC for the resident shareholder, the enterprise is seen to be carried on by the resident shareholder and is taxed in that resident's state.[249] The view of the CFC itself then switches. As the shareholder carries on the enterprise in the shareholder's state on the share of that income, the CFC state is the state where the shareholder has a permanent establishment.[250] That is because the CFC state is where the business is generated. That same approach is taken with respect to partially transparent entities that have distinct legal personalities or otherwise not legally transparent.[251]

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[245] Ibid para 7.
[246] Ibid on Article 1(2) para 9 (2017) It was also indirectly referenced in para 26.10 of the Commentary to Article 1 in the 2014 model tax convention.
[247] Article 1(2), OECD, *Model Tax Convention on Income and on Capital* (2017).
[248] Article 1(3), ibid.
[249] This was the result of *Grundlingh* supra note 38 which dealt with partnerships and tax treaties. The South African resident partner of a partnership based in Lesotho was not its own enterprise, the enterprise was the partner himself, resident in South Africa, carrying on business through a permanent establishment in Lesotho. This same logic is adapted from CFC rules by replacing 'partner' with 'shareholder' – proposed by Rust op cit note 47 and Lang, op cite note 160. See opposing view in the House of Lords in *Ostime (Inspector of Taxes) vs. Australian Mutual Provident Society* 1960 AC 459 at 481 where Lord Radcliffe stated that '…the hypothetical independent enterprise…violat[es] the very hypothesis which [the treaty] is designed to lay down as the basis of taxability'.
[250] See this operation for partnerships in Johann Hattingh 'The Tax Treatment of Cross-Border Partnerships under Model-Based Tax Treaties: Some Lessons from Grundlingh v. the Commissioner for South African Revenue Service' (2010) 127 *SALJ* 38 at 41.
[251] Angelo Nikolakakis & Stéphane Austry & John Avery Jones et al 'Some Reflections on the Proposed Revisions to the OECD Model and Commentaries, and on the Multilateral Instrument, with Respect to Fiscally Transparent Entities' (2017) 71 *Bulletin for International Taxation* at header 5.10, and fn. 146-7 of that article. OECD, *Model Tax Convention on Income and on Capital Commentary,* Commentary on Article 1, para 7 (2017).

For tax treaties, from the perspective that the shareholder has the enterprise, relief is then provided in Article 7(1) by way of a credit for foreign taxes that may have been paid by the CFC as the permanent establishment.[252]

Paragraph 11.1 of the 2017 commentary to Articles 23A and B provides a similar logic when resident/resident-based attributions occur (akin to CFC rules), that is, when the same income or capital may be taxed by each contracting state as income or capital of one of its residents.[253] Paragraph 8 of that commentary continues to provide an example that this treatment only applies to the state of the resident shareholder and does not prescribe how the CFC state has to proceed on relieving that same tax.[254]

Thus, in the case that the shareholder carries on the enterprise, Article 7(1) is given full effect for the shareholder. This means that the *'as if'* fiction from domestic tax law is also given a full effect and does not conflict with tax treaties. The question is if the result is any different to the view of National Treasury, that is, that tax treaties are unaffected by CFC rules because a CFC charge is a tax on different taxpayers?[255]

The only difference is that tax treaties may be considered in the cases of resident/resident-based attributions as described above. The effect, however, is precisely the same as simply providing a unilateral tax credit as stated by National Treasury and provided by section 9D without conflict.

b) Is the CFC the enterprise and is there a potential conflict with article 7(1) and the basis of taxation set by the definition of permanent establishment?

In this case, a CFC rule deems an amount of sales income to the owned by the shareholder, but the shareholder does not carry on the enterprise of the CFC. The applicability of Article 7(1) to the shareholder in that case is the double taxation arising from a resident/resident-based attribution on an amount of the same sales deemed to be owned and taxed for the shareholder

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[252] Article 23, OECD, *Model Tax Convention on Income and on Capital* (2017).
[253] OECD, *Model Tax Convention on Income and on Capital Commentary,* Commentary on Article 23A para 11.1.
[254] Ibid on Article 23A para 8.
[255] Discussed in Chapter 1.2.

in two resident states – following the logic of the *Anson* and *Smallwood* cases, and the view of Lang that Article 7(1) may relieve double economic taxation.[256]

A critical question arising from the above is how tax treaties address residence/residence-based taxation on the same profits of an enterprise without the concurrent enterprise or creation of a permanent establishment in the other state?

The solution to this question can be seen in Article 7(1), which determines that for the tax to be charged consistently on the CFC's enterprise in the shareholder state, that is, the profits of the CFC remain sourced from a foreign enterprise, there needs to exist a permanent establishment in the resident shareholder state for an amount of those same sales to be taxed therein. If no permanent establishment exists in the resident shareholder state, Article 7(1) may relieve the tax charged by a CFC rule.

The first example of this effect can be seen in the logic of *Fowler* regarding the tax on business profits when Mr Fowler was a non-resident and had no permanent establishment in the state the profits were taxed.[257] Recall that the *Fowler* case involved determining the *'as if'* fiction that treated employment income in the United Kingdom as carrying on a trade. Mr Fowler was a non-resident and taxed on the basis of a fictional trade arising from employment income he rendered in the United Kingdom.

As a non-resident, the tax authorities argued that the basis of taxation of business profits was the existence of a permanent establishment carried on by that foreign enterprise in the United Kingdom.[258] By simply treating the income from employment as the fictional profits from trade, Mr Fowler did not carry on business through a permanent establishment. The tax authorities therefore argued that this was an indication that the article 7 was not the appropriate tax treaty article to deal with tax on 'profits' without the creation of a permanent establishment.[259]

[256] Discussed in header 4.1.
[257] Discussed in Chapter 2.6. Note that this case did not deal with attributed income, that is, it was Mr. Fowler's income in both contracting states.
[258] *Martin Frederick Fowler* supra note 127 para 58.
[259] Ibid.

The First Tier Tribunal rejected the above argument, concluding that the scope of article 7(1) intended, without a doubt, to apply to tax that was charged on 'profits of a trade'.[260] What article 7(1) also required was for those profits to have arisen from the carrying on of business attributable to a permanent establishment in the United Kingdom. That view was also illustrated by the majority decision in the court of appeal, finding that tax treaty exemption applied to eliminate the charge on trading profits of non-residents without a permanent establishment in the United Kingdom.[261] That is, treating employment as trade did not also create a fictional permanent establishment for that income as a basis of taxability. The profits were therefore exempt without a permanent establishment.

The second and most significant example adopting this same logic, followed soon after the British decision of *Bricom* in the French decision of *Re Société Schneider Electric.*[262] The case dealt with French CFC rules that taxed the profitable results of a Swiss resident company for the French resident shareholder.[263]

The *Conseil D'etat* (French Supreme Administrative Court) found that the taxable profits in the name of the French shareholder company, had an identity in nature to the profits of the Swiss enterprise.[264] The profits attributable to a French enterprise based on the Swiss entity, taxed in Switzerland, were only taxable in France if the French resident entity carried on the enterprise which generated those profits through a permanent establishment in France. The case illustrated that article 7(1) may relieve double economic taxation in CFC rules, being the tax on the same profits of the Swiss CFC taxed in the name of the French shareholder because the profits attributable to French shareholders had to be derived through a permanent establishment in France to be taxed therein. The case resolved that:

> 'Consequently, one could deduce that since taxation established by internal law on certain income would lead indirectly, while the objective application of the convention would attribute to France the right to tax such income, to the contravention of other provisions of the convention, you should conclude that the convention prevents the taxation in France of this income.'[265]

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[260] Ibid paras 109, 111.
[261] *Fowler* supra note 16 para 41.
[262] *Schneider* supra note 43.
[263] Ibid at 1108. Note that following this judgment, the French CFC rules were amended to state the taxable object changed from business profits to deemed dividends.
[264] Ibid.
[265] Ibid at 1127.

In South Africa, a similar logic to the relationship between tax on profits and a permanent establishment for non-resident's was argued in the case of *L.J. Downing v SIR.*[266] Downing was a Swiss resident who held a portfolio investment of shares that was maintained by a general broker in South Africa that made substantial profits. The tax authorities sought to tax Mr Downing on profits. On appeal, the court found that in the absence of having a permanent establishment in South Africa, the business profits article 7(1) of the tax treaty with Switzerland provided an exemption from South African tax. The court held that if nothing more than 'profits' exists, there was no business carried on for the purpose of article 7(1) through a permanent establishment, finding:

> 'We have come to the conclusion, therefore, that it having been shown that the "business" in question was carried on otherwise than though a permanent establishment in the Republic, the appellant is exempt from tax in the Republic in respect of the profits, in terms of Article 7(1).'[267]

Therefore, article 7(1) determines that the profits from an enterprise of a contracting state are not taxable in South Africa, unless that enterprise has a permanent establishment in South Africa. That basis of argument was the same in case of the same taxpayer, such as *Fowler*, or one taxpayer based on another taxpayer, such as *Schneider.*

Thus, when South African CFC rules tax an amount of sales income of a foreign enterprise, that is not also attributable to a permanent establishment in South Africa, article 7(1) may exempt a CFC rule. In that case, a unilateral credit is not the same as tax treaty exemption. The view of National Treasury therefore conflicts with this logic.[268] In order to remedy this, an alternative hypothetical recourse is described as below.

c) Is there an alternative remedy (the tax saving clause)?

In states adopting a CFC rule, the design of these rules can be largely attributable to the United States who conceived and first enacted CFC legislation in 1962 to eliminate CFC deferral. From 1937 until the time of CFC legislation, the tax system in the United States already taxed corporate investment income, that is 'passive income', in foreign jurisdictions as sources

[266] *L.J. Downing v SIR* 1972 (37) SATC 249 (TC).
[267] Ibid.
[268] See the research problem in Chapter 1.2 of this minor dissertation.

deemed to in the United States through its passive holding company regime, by piercing the veil of the foreign entity owned by tax residents of the United States.[269]

This result was that the remaining 'active income' generated by the CFC itself was not taxed in order for United States domestic entities to remain competitive with their offshore counterparts.[270] For multinationals, the mobility of operations meant that the distinction as to what generated active income may have been of no economic consequence. The result that the holding company regime was ineffective on passive income effectively connected to the preponderance of active income. This position gave rise to avoidance.

The threat that diversion of business from the United States to lower tax jurisdictions for immediate tax savings had already grown, and in the 1950's the United States was running a large deficit for the first time in years with a record low economic growth rate of two per cent from a longstanding average of three.[271] Meanwhile other countries ravaged from World War II still reported double and triple-digit growth.[272]

A causal factor identified by the Kennedy Administration was the United States multinational investment in foreign subsidiaries, an issue remedied by introducing CFC rules. What CFC rules did was to look into the CFC's income, including sales and services, to tax the same income but as a source in the United States.[273] There are two fundamental components from this.

i. The effect of double taxation on the income in the CFC

Since the shareholders of the CFC were United States residents, those shareholders were subjected to unlimited taxation on the attributed CFC income sourced in the United States. What arose, however, was double taxation on the income deemed to be sourced in the United States that was also taxed in the CFC state. Unilateral relief was then available in the United States on the same income computed by way of a tax credit.

[269] Graetz, op cit note 47 at 217-222.
[270] Generally referred to as 'capital export neutrality'.
[271] Graetz, op cit note 47 at 217-222.
[272] Ibid.
[273] Ibid.

ii. The effect of CFC rules in tax treaties with the United States

Before CFC rules, foreign 'active income' like business profits, was not taxable in the United States.[274] The adoption of CFC rules in the interactions with tax treaties did not seem to be a question of consequence. An example appears in article 13(1) and (2) of the United States 1945 tax treaty with the United Kingdom, that affirmed the position of the United States and the taxation of United States nationals including corporate residents.[275]

Article 3 covered 'industrial and commercial profits', similar to OECD Model Tax Convention in Article 7. It generally distributed the taxing rights on profits of the CFC enterprise to the CFC state, unless it was carried on by a resident through a permanent establishment in the United States. Thus, by sourcing the CFC's income in the United States, the United States continued to tax the income of a CFC even when the non-resident CFC did not carry on an enterprise through a permanent establishment in the United States. Where the same income continued to be taxable in both countries, the solution in those situations was to be addressed by article 13 of that treaty; Article 13(1) and (2) stated:

> 13(1): Subject to section 131 of the United States Internal Revenue Code as in effect on the first day of January, 1945, United Kingdom tax shall be allowed as a credit against United States tax.
>
> 13(2): Subject to such provisions (which shall not affect the general principle hereof) as may be enacted in the United Kingdom, United States tax payable in respect of income from sources within the United States shall be allowed as a credit against any United Kingdom tax payable in respect of that income.[276]

Section 131 of the United States Internal Revenue Code was the provision which allowed relief by way of a foreign tax credit in respect of income also accrued to a foreign country during the taxable year. Article 13(2) established a general principle that relief by way of the tax treaty was limited to a tax credit when the United States also sourced the same income the tax treaty allocated. This addition was an extension of the unilateral provision that was also bilaterally inserted into the tax treaty in order to limit any tax treaty relief available for states contracted with the United States. By providing a tax credit, any contracting state with a rate of tax lower

[274] Ibid.
[275] *Anson* supra note 29 at 68-91.
[276] Ibid at 75.

than the United States would not be relieved, allowing the United States to eliminate the risks associated with deferral and diverted income.

In 1966, after adopting its CFC regime, the United States agreed a protocol to its tax treaty with the United Kingdom to amend article 13(2), which changed the reference from 'tax payable' to 'computed by reference to the same profits'. This was to identify that a domestic attribution would still qualify for tax treaty relief when the income computed resulting in double taxation was not the same character of income in two jurisdictions.[277]

In 1975, unrelated to the above, that tax treaty was renegotiated on the OECD model tax convention, and included a new provision in Article 1(3):

> Notwithstanding any provision of this Convention except paragraph 4 of this article, a contracting state may tax its residents ... and its nationals as if this Convention had not come into effect.[278]

Paragraph 1(3) contained a new tax 'saving clause' under which each contracting state reserved the right to tax its nationals and residents under article 4 as if the convention had not come into effect.[279] The savings clause was of principal importance to the United States because the United States taxed its citizens, residents, and corporations on a worldwide basis, regardless of where they resided or derived income.

Paragraph 1(4) detailed a number of exceptions to the general savings clause that reflected overriding policies to the treaty distributive rules.[280] Most importantly, the exception did not restrict benefits to the elimination of double taxation provided in article 23 [which was article 13(2) as it was in the 1945 tax treaty and 1966 protocol]. The business profits article, article 7, was not one of the exceptions, which meant the relief from double taxation by way of article 7 resorted to the basis of relief as it was detailed in article 23 (as it were in 1945 and 1966).

[277] Ibid at 81, referring to the decision of the House of Lords in *Duckering v Gollan* 1965 (1) WLR 680 and the double taxation in two jurisdictions on the same income that had a different character in each state.
[278] See article 1(3) in the technical explanation to the 1975 tax treaty at https://www.irs.gov/pub/irs-trty/uktech.pdf, last accessed 30 June 2019.
[279] Ibid.
[280] See article 1(4) in ibid.

Thus, the basis of attributing business profits in the form of CFC income, because it was also a deemed source rule in the United States, was not affected by the exemption requirements provided in article 7 on that same income. This arose because article 7 was subject to article 23, and therefore exemption by way of article 7 was limited to relief provided by way of credit when the income was also sourced in the United States by way of article 23. In all other cases, article 7 was unaffected as it allowed for exemption of all foreign active business that was not otherwise sourced in the United States by CFC rules.

CFC rules were, therefore, never a conceptual issue for the United States when their tax treaties included an express override to tax treaty benefits, even when the character of the CFC income was unchanged.

From the above view, it is submitted that the tax arising from a domestic CFC rule still has to be interpreted in the context of tax treaties, on the basis that CFC rules could not themselves override tax treaties for covered persons. As explained next, an over-ride clause may play an important role.

When the effect of a CFC rule is such that a CFC is taxed on a residence-basis of taxation in the CFC's tax resident state, and the shareholder of a CFC is taxed based on a CFC's profit arising from a CFC rule in the shareholder's tax resident state, there is a resident/resident-based form of double taxation. Since the CFC itself never becomes a tax resident in the shareholder state, but in effect is taxed on a resident basis of on an amount therein in the hands of the shareholder, from the shareholder's view, a question may arises as to the source of the income for the purposes of tax treaties. Since tax treaties have their own sourcing rules[281], a tax treaty that applies to the shareholder who is a tax resident may, therefore, require that income to be attributed in accordance with the rule of the model tax convention.

Before this discussion, however, and by way of contrast, recall that the finding in *Bricom* was that the tax arising from a CFC rule was based on notional income. In this view, it has been found that the amount of 'income' subject to tax had no particular source[282], even in tax treaties. The amount that was taxed based on the income generated by the CFC would not fall into tax

[281] *Anson* supra note 29 at 98.
[282] See, for example, M. Ullah op cit note 114.

treaties on the basis of source rules, even when the amount was essentially the same CFC income. An amount of notional income would, therefore, not necessarily override tax treaties because the income itself was not the same income as the CFC.

As it stands, however, South Africa has a variety of tax treaties that have a *'subject to'* override clause in the relief articles that would not preclude application of CFC rules should the concept of notional income and notional source be contested. One being article 22 of the Australia tax treaty (1997), article 22(3) of the Canada tax treaty (1997), Article 21(3) with the United Kingdom tax treaty (2003), and Article 21(2)(c) in the United States tax treaty (1997).[283] No such clause exists for example, in the relief articles of the German tax treaty (1975), the Luxembourg tax treaty (2000), the Netherlands tax treaty (2009), the New Zealand tax treaty (2002), the Singapore tax treaty (2017), the Switzerland tax treaty (2009), the Swedish tax treaty (1998) or the United Arab Emirates tax treaty (2016). The significance of this clause is explained below.

iii. Interaction with tax treaties with an override clause in South Africa

Article 7(1) would not apply to section 9D when tax treaties contain an override clause. If there is a subject to tax clause, it is necessary to refer to that method of relief first.

For example, the South Africa-United Kingdom tax treaty (2003) states for the elimination of double taxation:

> 21(2)(a): 'South African tax payable under the laws of South Africa and in accordance with this Convention…shall be allowed as a credit against any United Kingdom tax computed by reference to the same profits, income or chargeable gains by reference to which the South African tax is computed'
>
> 21(3): 'For the purposes of paragraph 2 of this Article, profits, income and capital gains owned by a resident of the United Kingdom which may be taxed in South Africa in accordance with this Convention shall be deemed to arise from sources in South Africa.'[284]

[283] This list is by no means exhaustive but is illustrative of the potential issue. See a discussion in 'Analysis of a 'subject to tax' clause reform under South Africa's income tax legislation' in Ashley Olivier, 'An analysis of options for reform of South Africa's unilateral income tax exemption of foreign pensions, with an emphasis on the cross-border interaction with pensions derived from the United Kingdom and Germany', LLM thesis (UCT), 2018 fn 174.
[284] Article 21(2)(a) and 22(3), South Africa-United Kingdom tax treaty (2003).

21(2)(a) is not itself conclusive as the tax that arises must be 'in accordance with the convention'. Article 7(1) sets the basis of taxation that limits the source state, being South Africa, from taxing the sales income of the CFC unless it is attributable to a permanent establishment of the enterprise.[285] In accordance with the convention, that income is, therefore, exempt from tax and prevents a CFC charge.

Article 21(3) then intervenes, in that, for the purposes of 21(2), the amount of taxable sales is deemed to arise from sources in South Africa when the convention allows taxation in another state. In article 7(1), South Africa may only levy tax on an amount of sales income sourced from the CFC when the amount of sales are attributable to a permanent establishment in South Africa. Thus, it is submitted that the inclusion of Article 21(3) may create a fictional sourcing rule for the purposes of article 7(1), that is, akin to the shareholder carrying on a fictional business in the form of a fictional 'deemed' permanent establishment. A deemed permanent establishment would effectively source accord with article 7(1).

The override clause, therefore, allows taxation by way of CFC rules in South Africa without relief by way of Article 7(1). This is by creating a 'deemed' permanent establishment and relief being provided by way of tax credit. This effect is, therefore, the same as a unilateral credit without tax treaty relief.

4.5. CFC rule developments in the OECD Model Tax Convention

In addition to the new fiscal transparency clause as discussed in this chapter,[286] there have been several updates to the OECD model tax convention in order to address the perceived conflict with CFC rules in tax treaties. More notably, the 2017 update to the model tax convention which resembles the 'saving clause' on United States citizens as discussed above.

Before this, however, the OECD acknowledged the *Bricom* decision by amending the 2003 Commentary to the model tax convention for the so-called *tax on residents*.[287] Paragraph 14 of the Commentary to article 7(1) states:

[285] Discussed in 4.4(b).
[286] Discussed in 4.4(a).
[287] OECD, *Model Tax Convention on Income and on Capital: Commentary,* Commentary on Article 1 (2017) paras 17-8, 81 (2017 addition), Commentary on Article 7 (2017) para 14 (2010 addition) formerly para 10.1 (2003 addition now deleted); De Broe op cite note 43 para 394.

> The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. As confirmed by paragraph 3 of Article 1, the paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law, even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise.[288]

That view confirmed that a CFC rule was not prevented by tax treaties simply because the income attributed to a state's own resident was also computed *by reference to* the income of another resident in a foreign jurisdiction. That is, it confirmed the concept of a purely *notional* income as was held in *Bricom*. The status of Commentaries as binding context has created much in the way of debate, however.[289] Thus, more recently, the OECD may have affirmed the above position with the introduction of the 'saving clause' in article 1(3) of the 2017 OECD model tax convention on the relationship between the tax on residents and tax treaties.[290] This concretised the view that that even where the concept of *notional* income may be contested, Article 7(1) may not provide relief from double economic taxation. This wording appears to be very similar to the operation of the saving clause conceived by the United States discussed above.

Article 1(3) states:

> 'This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.'

Article 7(1) is not one of the above exceptions. Thus, it appears that the double economic taxation arising from a CFC rule may not be provided relief through Article 7(1), as a tax arising on resident/resident-based attributions.

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[288] OECD, *Model Tax Convention on Income and on Capital: Commentary*, Commentary on Article 7 para 14 (2017) first appearing in 2003.

[289] John F. Avery-Jones, *Treaty Interpretation* (Global Tax Treaty Commentaries IBFD 2018) at 38 para 3.11.1.2; J Hattingh 'The Multilateral Instrument from a Legal Perspective: What May Be the Challenges? ' (2017) 71(3/4) *Bulletin for International Taxation* at header 6.3; L Steenkamp 'The use of the OECD Model Tax Convention as an Interpretative Aid: The Static vs Ambulatory Approach Debate Considered from a South African Perspective' (2017) 10(2) *Journal for Economic and Financial Sciences 195.*

[290] Article 1(3) OECD, *Model Tax Convention on Income and on Capital* (2017).

In addition, paragraph 1 of article 23A, which provides relief by way of tax treaty exemption is also restricted, and now applies:

> '…except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State'[291] [that is, subject to Article 1(3)].

4.6. Summary of findings

This chapter looked at a hypothetical fact pattern using sales income from a CFC as the basis of an *'as if'* fiction in South African CFC rules. At a domestic level, unlike the *Bricom* case, Chapters Two and Three built on the presumption that the *'as if'* fiction may not have been purely notional. The *Fowler* case confirmed an alternative view that supported the *'as if'* akin to statutory deeming. With that finding, a CFC rule taxes the CFC shareholder on an amount of the same CFC's income, which in this chapter used an example of deemed sales income. A CFC rule, therefore, results in a resident/resident-based form of double taxation, because the effect of a CFC rule is such that a CFC is taxed on a residence-basis of taxation in the CFC's tax resident state, and the shareholder of a CFC is taxed based on a CFC's profit arising from a CFC rule in the shareholder's tax resident state.

The most likely conflict with CFC rules and tax treaties would arise with Article 7(1) because the view is that an enterprise and profits may be separate concepts. In tax treaties, for South African CFC rules to apply, the resident shareholder must generate the profits by carrying on an enterprise and not simply being taxed on profits. That effect found one of two potential outcomes that could source the same 'income' in South Africa in accordance with tax treaties.

The first was that the shareholder carried on the enterprise and thus the income was the income of the shareholder's enterprise, which meant that the CFC was treated as fiscally transparent in a sense. Thus, the view in Article 7(1) switched the CFC as an enterprise to the CFC as a permanent establishment. This was, in effect, the same as providing a unilateral tax credit for foreign taxes paid in the CFC state. This also accorded with the new Article 1(2) of the 2017 OECD Model Tax Convention that includes a new transparency clause.

[291] Article 23A para 1, ibid.

The second was that the CFC was the enterprise and the income was taxed for the resident shareholder. In this way, what occurred was a conflict with section 7(1) as the taxpayer needed to have an enterprise with a permanent establishment and not merely profits to tax the CFC enterprise in South Africa. To remedy this scenario, there are override clauses in certain of South Africa's tax treaties, similar to the United States, that finds that income taxed in South Africa is also sourced in South Africa.

This also accords with the new 'tax saving' clause included in the 2007 OECD Model Tax Convention. Using an amount of sales income as an example, this means that the sourcing rule deems the enterprise to transfer to the shareholder and create a permanent establishment, thus, South Africa's CFC rule may not conflict with tax treaties.

CHAPTER FIVE – CONCLUSION

This minor dissertation determined that the effect of the *'as if'* statutory fiction is not a notional definition but rather, a deeming rule. The finding arose in the *Bricom* case which determined that an *'as if'* fiction was defined notionally and was, therefore, not the actual 'income' itself, but an amount based on actual income. Thus, if X was taxed *'as if'* it was Y, the *'as if'* introduced a fictional element that was not the same as Y's actual income. The tax computed on an amount *'as if'* it was Y's income was, therefore, not the same as Y's actual income. The result was that the fiction *'as if'* it was Y was a distinct concept separate from Y and, therefore, not the same income. The notional amount was not, therefore, afforded tax treaty relief.

In *Fowler*, the effect of *'as if'* re-emerged as a deeming rule, that is to say, it was not a notional definition and the fiction supported the full ordinary meaning being provided to the *'as if'* terminology. Thus, the logic follows that if X was taxed *'as if'* it was Y, it was Y's same income that was taxed for X. The tax computed with reference to a fictional amount of Y's income and Y's actual income meant they were one and the same. Thus, if they are to be regarded as the same income, they were not separate concepts and could not be notionally defined. The result was that the tax on X *'as if'* it was Y was, therefore, calculated on Y's actual income. The income was, therefore, subject to tax treaty relief.

The theory of *'as if'* formulated by *Vaihinger* and the theoretical effect of *'as if'* regarded one subject matter 'just as' another. The case of *Fowler* thus accorded with this theory as it meant that the *'as if'* fiction had a deeming aspect which was the same as the nature of the income that it was deemed to be. In regard to the case of two taxpayers, for example a CFC and the shareholder, this meant that taxpayer X was taxed *'as if'* X was Y, which meant that Y was 'just as' X – it was therefore the same income of Y for X. Accordingly, the *'as if'* was not a notional definition, but a deeming rule of Y's income or activity for X.

In addition, caselaw generally supported the view to domestic fictions, which stated that an ordinary meaning could be given to fiction. The fictional definition was, therefore, not a notional definition. In addition, a fiction which was a computation based on or computed with reference to actual income, simply meant it was the same income that was taxed, and was therefore, not a notional amount. Thus, reading the definition of net income with the terms *'as* *if'*, simply meant that the shareholder is taxed just as the CFC and just as the CFC was a tax resident taxpayer, akin to a deeming rule on the same CFC's income or activity.

By consolidating the above views in CFC rules, the *'as if'* results in the taxation of one resident taxpayer – the CFC, and the taxation on that same income attributed to another taxpayer, the shareholder – a resident/resident-based attribution of double taxation therefore arises. In these cases, tax treaty relief may be afforded to taxpayers when the tax in one state was computed with reference to the same income in the hands of two different tax residents – so called, double economic taxation. That is, when one taxpayer's income was used to determine the tax liability of the other taxpayer, as was found in the *Anson* and *Smallwood* cases respectively.

The above findings were tested in a hypothetical case study using 'sales' income in a CFC. The effect of *'as if'* meant that the shareholder was taxed on an amount of deemed sales from the CFC. In tax treaties, Article 7(1) had a potential conflict with CFC rules by questioning who carries on the business generating the sales, that is, who is regarded as carrying on the enterprise. That effect found one of two potential views to the same sales in South Africa in accordance with Article 7(1).

The first was that the shareholder carried on the enterprise and thus the amount of income was the income of the shareholder's enterprise, which meant that the CFC was treated as fiscally transparent in a sense. Thus, the view in Article 7(1) switched the CFC as an enterprise to the CFC as a permanent establishment. This was, in effect, the same as providing a unilateral tax credit for foreign taxes paid in the CFC state. This also accorded with the new Article 1(2) of the 2017 OECD Model Tax Convention that includes a new transparency clause.

The second was that the CFC was the enterprise and the resident shareholder was taxed on an amount of business profits from a non-resident (the CFC's) enterprise. In this way, what occurred was a conflict with article 7(1) because the shareholder did not carry on the enterprise of the CFC or create a permanent establishment to which the sales were attributed. To remedy this scenario, there are 'saving' override clauses in certain of South Africa's tax treaties similar to the United States that finds that income taxed in South Africa is also sourced in South Africa, creating a 'deemed' permanent establishment as the basis of taxation to align with article 7(1).

The above effect is similar to the new ‘tax saving’ clause in article 1(3) included in the 2017 OECD Model Tax Convention which limits the tax treaty exemption arising from Article 7(1) when applied to a tax on different residents based on the same income taxed by two tax jurisdictions.

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